FEDERAL HOUSING FINANCE AGENCY

OFFICE OF INSPECTOR GENERAL

Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs

EVALUATION REPORT: EVL 2011 002 DATED: MARCH 31, 2011

FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

AT A GLANCE

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Why We Did This Evaluation

In September 2008, the Federal Housing Finance Agency (FHFA/Agency) placed the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises), into conservatorships due to their mounting losses. Since then, the U.S. Department of the Treasury (Treasury) has invested over $153 billion in the Enterprises to stabilize them. As conservator, FHFA has taken a range of actions to improve the Enterprises' finances and operations, including removing and replacing senior executives and establishing new executive pay plans. FHFA oversees the Enterprises' executive compensation levels and monitors their ongoing implementation. In 2009 and 2010, FHFA approved executive compensation packages totaling more than $35 million in annual base salaries and deferred performance pay for the Enterprises' top six officers.

Given the concerns about executive compensation levels at companies that have received federal financial support, the FHFA Office of Inspector General (FHFA-OIG) initiated this evaluation to assess: (1) the processes used to develop the Enterprises' compensation packages; (2) FHFA's ongoing oversight efforts; and (3) the transparency of the Enterprises' executive compensation policies and practices.

What We Recommend

FHFA should establish an ongoing review and analysis process to include such issues as the level of federal support for the Enterprises, and the compensation levels for the heads of housing-related federal entities. Additionally, FHFA should establish written criteria and procedures for reviewing performance data, and conduct independent verification and testing of the basis for executive compensation levels. These factors may warrant lower compensation for Enterprise executives. Also, to improve transparency, FHFA should post on its website information about executive compensation, and provide links to the Enterprises' securities filings. FHFA agreed with most, but not all, of these recommendations.

What We Found

FHFA coordinated with Treasury and outside consultants to develop the Enterprises' compensation programs. FHFA believes that such programs are necessary to recruit and retain talented executives. Enterprise executive compensation packages include provisions designed to mitigate abusive compensation practices, such as "golden parachute" severance payments. However, FHFA has not considered factors that might have resulted in reduced executive compensation costs, such as the impact that federal financial support has on the Enterprises' corporate and executive perfomance, and the compensation paid to senior officials at federal entities that also play a critical role in housing finance.

FHFA lacks key controls necessary to monitor the Enterprises' ongoing executive compensation decisions under the approved packages. Specifically, FHFA has neither developed written procedures to evaluate the Enterprises' recommended compensation levels each year, nor required Agency staff to verify and test the means by which the Enterprises calculate their recommended compensation levels. Although the Agency apparently is enhancing its procedures, which is a positive development, the new procedures do not address all of FHFA-OIG's concerns, such as FHFA's lack of testing and verification of the Enterprises' submissions in support of executive compensation packages.

FHFA also does not provide sufficient transparency to the public of the Enterprises' executive compensation programs. Although the Enterprises report relevant information in public securities filings, more user-friendly information is generally unavailable. For example, FHFA does not post the Enterprises' executive compensation data or related trend data on its website.

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ABBREVIATIONS

CEO	Chief Executive Officer
CFO	Chief Financial Officer
COO	Chief Operating Officer
DER	Division of Enterprise Regulation
EVP	Executive Vice President
FANNIE MAE	Federal National Mortgage Association
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHFA-OIG	Federal Housing Finance Agency, Office of Inspector General
FREDDIE MAC	Federal Home Loan Mortgage Corporation
GAO	Government Accountability Office
GINNIE MAE	Government National Mortgage Association
GSE	Government-Sponsored Enterprises
HERA	Housing and Economic Recovery Act of 2008
HUD	Department of Housing and Urban Development
MBS	Mortgage-Backed Securities
OCO	Office of Conservatorship Operations
OFHEO	Office of Federal Housing Enterprise Oversight
OMB	Office of Management and Budget
OPAR	Office of Policy Analysis and Research
SEC	U.S. Securities and Exchange Commission
SPSPA	Senior Preferred Stock Purchase Agreement
TARP	Troubled Asset Relief Program
TREASURY	U.S. Department of the Treasury

Office of Inspector General
Federal Housing Finance Agency
Washington, DC

PREFACE

The Federal Housing Finance Agency (FHFA/Agency) Office of Inspector General (FHFA-OIG) was established by the Housing and Economic Recovery Act of 2008 (HERA) (Public Law No. 110-289), which amended the Inspector General Act of 1978 (Public Law No. 95-452), to conduct audits, investigations, and other activities of the programs and operations of FHFA; to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them. This is one of a series of audits, evaluations, and special reports published as part of FHFA-OIG's oversight responsibilities to promote economy, effectiveness, and efficiency in the administration of FHFA's programs.

This evaluation assesses FHFA's development and oversight of the executive compensation programs of the Federal National Mortgage Association (Fannie Mae) and the Federal National Mortgage Corporation (Freddie Mac) as well as the transparency of their compensation programs. The evaluation is based on interviews with FHFA employees and officials, direct observations, and a review of applicable documents.

The recommendations herein have been developed with the best knowledge available to FHFA-OIG and have been discussed in draft with those responsible for implementation. FHFA-OIG trusts that this evaluation will result in more effective, efficient, and economical operations. FHFA-OIG expresses its appreciation to all those who contributed to the preparation of this evaluation.

This evaluation has been distributed to Congress, FHFA, the Office of Management and Budget, and others, and the report will be posted on FHFA-OIG's website, http://www.fhfaoig.gov/.

Richard Parker
Acting Deputy Inspector General for Evaluation

PURPOSE OF EVALUATION

The purpose of this evaluation was to assess the Federal Housing Finance Agency's (FHFA/Agency) development and oversight of the executive compensation programs of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

Fannie Mae and Freddie Mac (collectively, the Enterprises) are housing government-sponsored enterprises (GSEs) that were established, among other reasons, to help provide liquidity to the housing finance system, including during periods of economic stress. In 2007 and 2008, the U.S. housing finance system suffered its worst downturn since the Great Depression, and Fannie Mae and Freddie Mac lost billions of dollars. In September 2008, as the Enterprises' losses mounted, FHFA placed them into conservatorships, and the U.S. Department of the Treasury (Treasury) began providing substantial financial support.[1] As of February 25, 2011, Treasury had invested more than $153 billion in the Enterprises, and FHFA estimates that the total taxpayer commitment to the Enterprises could range from $221 billion to $363 billion through 2013.[2] Because the housing finance crisis has continued and private-sector financing has plummeted, the federal government - through the Enterprises, the Federal Housing Administration (FHA), and the Government National Mortgage Association (Ginnie Mae) - now dominates the housing finance market. For instance, as of the third quarter of 2010, the Enterprises financed approximately 67 percent of all newly originated mortgage securities, and Ginnie Mae financed about 29 percent.[3]

As the Enterprises' conservator, FHFA has taken a range of actions to manage, control, and improve the Enterprises' finances and operations and potentially reduce long-term costs to taxpayers. For example, at the inception of the Enterprises' conservatorships, FHFA terminated certain members of the Enterprises' boards of directors and certain senior officers, and replaced them with individuals that FHFA believes to be well-qualified and capable of improving business practices and operations. FHFA also reviews and approves on an annual basis executive compensation packages for the senior officers at each Enterprise, and monitors their performance in meeting established performance targets.

In late 2009, FHFA approved executive compensation packages for the Enterprises' Chief Executive Officers (CEOs), Chief Operating Officers (COOs),[4] Chief Financial Officers (CFOs), Executive Vice Presidents (EVPs), and those Senior Vice Presidents in charge of principal business units or functions. The packages are retroactive to January 1, 2009, and will remain in effect as long as the Enterprises remain in

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[1] Additionally, in November 2008, the Federal Reserve announced a program to purchase up to $1.25 trillion of the Enterprises' mortgage-backed securities.

[2] FHFA press release, October 21, 2010, available at http://www.fhfa.gov/webfiles/19409/Projections_102110.pdf.

[3] FHFA, Third Quarter 2010 Conservator Report, available at http://www.fhfa.gov/webfiles/19585/Conservator's_Report112910.pdf.

[4] Neither Enterprise use the specific term COO, however, they both employ senior executives who perform COO functions. Specifically, the Chief Administrative Officer(s) and General Counsel(s) perform COO functions. For purposes of simplicity, FHFA-OIG uses COO as a general term to describe the Chief Administrative Officer and General Counsel positions if they perform COO functions.

conservatorships, unless FHFA acts to change them. Under the packages, the Enterprises' two CEOs received approximately $17 million in combined compensation in 2009 and 2010. During the same period, the Enterprises' top six officers (their CEOs, COOs, and CFOs) received total combined compensation of more than $35 million. Under the FHFA approved compensation packages, the executives' total compensation for 2009 was to be paid out as of March 15, 2011, and the entirety of their 2010 compensation is to be paid out no later than March 15, 2012.

The level at which the Enterprises' senior executives are compensated has long been a subject of considerable public controversy. Some claim that prior to the conservatorships, the Enterprises' compensation structures lacked transparency and encouraged executives to inflate the companies' reported earnings and manipulate their financial statements. Moreover, such criticism has continued following FHFA's adoption of multi-million dollar executive compensation packages for the Enterprises in 2009. For instance, some have noted that, although the Enterprises have lost billions of dollars and continue to depend upon federal support to remain in business,[5] their senior executives continue to receive multi-million dollar salaries. Indeed, some have contended that the Enterprises' executives should be compensated at the same levels as federal agency employees.[6]

FHFA officials have justified the salaries paid to the Enterprises' senior executives on several grounds. They state that significant compensation is necessary to:

1. Recruit and retain talented executives who can run large and complex companies;
2. Provide incentives for the executives to meet performance targets;
3. Restore the Enterprises' finances and operations;
4. Off-set the disincentive created by the pending policy proposals calling for the winding down of the Enterprises;[7] and
5. Potentially minimize taxpayer costs associated with the conservatorships.

The Enterprises are not the only companies receiving federal government support for which executive compensation has been a controversial topic. Since 2008, Treasury has used the Troubled Asset Relief Program (TARP) to provide hundreds of billions of dollars in support to automobile and financial services companies. Treasury created a specific office, the Special Master for TARP Executive Compensation, to

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[5] House Financial Services Committee Hearing, February 25, 2010, available at http://financialservices.house.gov/hearings/hearingDetails.aspx?newsid=1103.

[6] *See*, *e.g.*, Statement of Mark A. Calabria of the *Cato Institute* before the Subcommittee on Capital Markets and Government Sponsored Enterprises, House Financial Services Committee, February 9, 2011, available at http://www.cato.org/pub_display.php?pub_id=12774 ("I recommend that all GSE employees be transitioned to the GS pay scale as soon as possible.")

[7] Recently, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), the Departments of Treasury and Housing and Urban Development issued a report on reforming the housing finance system, which included recommendations for the phase-out of the Enterprises. *Reforming America's Housing Finance Market: A Report to Congress* (Feb. 11, 2011), available at http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.

review and approve the compensation of senior executives of some TARP recipients. But the TARP compensation rules do not apply to the Enterprises because they have not received TARP funds.[8]

Given the controversy surrounding the issue of executive compensation, the FHFA Office of Inspector General (FHFA-OIG) initiated this evaluation to:

1. Evaluate the steps FHFA has taken to assess the reasonableness of the Enterprise compensation packages subsequent to their approval in 2009;
2. Assess FHFA's ongoing oversight of the Enterprises' executive compensation pursuant to the approved packages; and
3. Examine the transparency of the Enterprises' compensation policies and practices.

[8] The Enterprises have received federal government support under a different statute, the Housing and Economic Recovery Act of 2008 (HERA).

SCOPE AND METHODOLOGY

To gain an understanding of the process by which executive compensation is established at Fannie Mae and Freddie Mac, and the role that FHFA plays in this process, FHFA-OIG conducted a range of interviews with senior FHFA officials. In particular, FHFA-OIG interviewed FHFA's Chief Economist who, as head of the Office of Policy Analysis and Research (OPAR), has played a key role in the Agency's ongoing oversight of executive compensation. FHFA-OIG also interviewed OPAR staff and the Office of Conservatorship Operations (OCO) personnel. Some individuals were interviewed more than once.

FHFA-OIG also requested that FHFA provide all documentation related to its development of the Enterprises' executive compensation packages. FHFA-OIG reviewed all the documentation provided by FHFA, including briefing slides prepared by a compensation consultant hired by FHFA to help determine the appropriate levels of compensation. Further, FHFA-OIG examined documents in the public domain, including materials on FHFA's website, U.S. Securities and Exchange Commission (SEC) filings, FHFA media statements, information posted on Fannie Mae's and Freddie Mac's websites, and documents available from the Treasury's Office of Financial Stability, which administers the TARP programs. In particular, FHFA-OIG reviewed the reports and determination letters released by the Special Master for TARP Executive Compensation, and SEC filings made by TARP-assisted companies and other financial firms.

This FHFA-OIG evaluation was conducted under the authority of the Inspector General Act of 1978, as amended, and in accordance with the Quality Standards for Inspection and Evaluation (January 2011), which have been promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards, which are generally accepted by federal government agencies, require FHFA-OIG to plan and perform an evaluation so as to obtain evidence sufficient to provide reasonable bases to support findings and conclusions. FHFA-OIG trusts that the evidence discussed here meets these standards. The performance period for this evaluation was from January 2011 to March 2011.

We provided FHFA staff with briefings and presentations concerning the results of our fieldwork and the information summarized in this evaluation.

We appreciate the efforts of FHFA management and staff in providing the information and access to necessary documents to accomplish this evaluation. Appendix C identifies major FHFA-OIG contributors to this evaluation.

BACKGROUND

To fulfill their charter and legislative obligations to provide liquidity and support to the residential mortgage finance system, the Enterprises have participated in the creation and development of the **secondary mortgage market**. In this market, which is only open to companies that originate mortgages such as banks and thrifts, the Enterprises purchase residential mortgages from mortgage originators that meet their underwriting standards. The originators can use the proceeds of the sales of mortgages to the Enterprises to issue new residential mortgages. The Enterprises hold some of the mortgages they purchase in their retained investment portfolios, and package the rest into **mortgage-backed securities** (MBS),[9] which they sell to investors on the secondary market. As part of the process, the Enterprises also, in exchange for a fee, guarantee the timely payment of interest and principal on MBS that they issue.

***Secondary Mortgage Market** is a market in which mortgages or mortgage-backed securities are bought and sold. It allows banks to sell mortgages, giving them new funds to offer more mortgages to new borrowers. See http://useconomy.about.com/od/glossary/g/secondary_marke.htm*

***Mortgage-Backed Securities** are created when a sponsor buys up mortgages from lenders, pools them, and packages them for sale to the public, a process known as securitization. See http://financial-dictionary.thefreedictionary.com/Mortgage-Backed+Security*

When the housing market began to collapse in 2007 and 2008, the Enterprises lost billions of dollars on investments and MBS guarantees. On September 6, 2008, as the Enterprises' losses mounted, FHFA placed them into conservatorships, and Treasury committed to provide billions of dollars in support to the Enterprises in the form of preferred stock purchases. Under the terms of the senior preferred stock purchase agreements (SPSPAs) with each Enterprise, Treasury purchased preferred shares in the Enterprises, thereby enabling them to meet existing financial obligations and remain solvent. Through the fourth quarter of 2010, Treasury had purchased more than $153 billion in preferred shares of the Enterprises.

As the Enterprises' conservator and primary regulator, FHFA has broad powers to control and direct the Enterprises' business activities. For instance, FHFA has replaced some members of their boards of directors and senior officers. FHFA also reviews and authorizes the terms and amounts of compensation paid to the Enterprises' executives. Treasury, under the terms of the SPSPAs, also exercises a degree of authority over the Enterprises' executive compensation. Under the SPSPAs, Treasury must be consulted regarding the Enterprises' executive compensation arrangements with senior officers.

[9] A more detailed discussion of MBS can be found at http://www.sec.gov/answers/mortgagesecurities.htm.

FHA and Ginnie Mae are also relevant to this evaluation. Congress established FHA, now an agency within HUD, in 1934 to broaden homeownership, protect and sustain lending institutions, and stimulate employment in the building industry. FHA insures a variety of mortgages for initial home purchases, construction and rehabilitation, and refinancing on mortgages that meet FHA criteria. FHA has played a particularly large role among minority, lower-income, and first-time homebuyers.

Ginnie Mae, also a unit of HUD, acts like the Enterprises, as a guarantor of timely payment of interest and principal for certain MBS. Specifically, Ginnie Mae guarantees apply to MBS collateralized by FHA-insured and other government-guaranteed mortgages. Unlike the Enterprises, Ginnie Mae does not buy and hold mortgages in investment portfolios nor does it issue MBS. Instead, lenders or securitizers issue the MBS on which Ginnie Mae provides guarantees.

Other areas that are important for a broader understanding of the issues raised herein follow.

1. FHFA Developed the Enterprises' Executive Compensation Packages in Coordination with the Treasury Special Master for TARP Executive Compensation and Outside Consultants

In late 2008 and 2009, FHFA and Treasury developed the Enterprises' executive compensation packages in consultation with the TARP Special Master, a compensation consulting firm retained by the Agency, and compensation firms retained by the Enterprises. In Congressional testimony, FHFA's Acting Director stated that the principal goal of the executive compensation plan development process was to create a system that provides the Enterprises' executives with compensation packages that are sufficient to achieve the goals of the conservatorship, align executive decision-making with the long-term financial prospects of the Enterprises, and minimize costs to the taxpayers.[10] Another critical FHFA concern is to ensure that the Enterprises can recruit and retain talented executives and professionals. This concern has been heightened by the Administration's recent proposal, which recommends that the Enterprises in their current form be phased-out.

In developing the Enterprises' executive compensation packages, FHFA considered the compensation approaches that Treasury's Special Master developed for companies that received financial assistance under the TARP. However, an FHFA official advised that the Enterprises' plans vary from those of the TARP companies with respect to stock-based compensation because, post-conservatorship, the value of the Enterprises' stock has remained near zero. As a result, the Enterprises' executives receive entirely cash-based compensation packages (by contrast some TARP recipients' executives receive substantial compensation in the form of company stock). In arriving at their executive compensation plans, FHFA also considered information and analysis provided by a compensation consulting firm it hired, as well as outside compensation consultants hired by the Enterprises.[11] Those consultants assisted the Enterprises in

[10] House Financial Services Committee Hearing, February 25, 2010, available at http://financialservices.house.gov/hearings/hearingDetails.aspx?newsid=1103.

[11] FHFA paid the outside compensation consultant it hired $403,000 in 2010. During the same period, Fannie Mae and Freddie Mac paid their outside compensation consultants $655,000 and $560,000, respectively.

identifying comparable firms, such as large banks and insurance companies, to provide a basis for assessing whether the Enterprises were in line with what similar organizations paid their executives.[12]

2. Enterprise Executive Compensation Is Largely Tied to Corporate Performance

FHFA officials have stated that the Enterprises' executive compensation levels are largely based on whether the Enterprises meet pre-established financial and performance targets. Table 1, below, shows examples of each Enterprise's 2010 financial and performance goals and measures that are tied to executive compensation levels. As depicted, Fannie Mae set a goal of maintaining its single-family credit related expenses, such as foreclosure expenses, at no more than $45.5 billion. Fannie Mae officials have reported that the goal was met, as credit-related expenses were $26 billion in 2010. Similarly, Freddie Mac set a target of maintaining its retained mortgage portfolio at $810 billon or less, and it met that goal.

Although FHFA appears to have ensured that the Enterprises' executive compensation levels are closely linked to objective performance measures, the overall success of FHFA's oversight is largely dependent upon the quality of the metrics that are used. FHFA-OIG did not review these performance measures as part of this evaluation. However, as discussed at Finding 2.A, below, FHFA-OIG found that there is room for FHFA to improve its procedures. Specifically, FHFA should adopt written criteria and other controls for evaluating the Enterprises' performance measures. Furthermore, federal support for the Enterprises under conservatorship may affect the validity of certain performance metrics, namely, by causing executive and corporate performance to be overstated (*see* Finding 1, below, at recommendation (B)), and, by extension, providing executives with compensation that is not warranted.

Table 1: Select Fannie Mae and Freddie Mac Financial Performance Goals and Measures, 2010

ENTERPRISE	GOALS	EXAMPLES OF MEASURES
FANNIE MAE	Provide liquidity, stability and affordability to the US housing and mortgage markets	Single-family credit related expenses of $45.5 billion or lower
FREDDIE MAC	Financial Execution	Retained mortgage portfolio balance below $810 billion (per Treasury's SPSPA)

Source: Fannie Mae and Freddie Mac 2010 SEC 10-K Filings, available at http://www.sec.gov/edgar/searchedgar/companysearch.html

The key provisions of the Enterprises' executive compensation packages consist of three elements: Base Salary, Deferred Base Salary, and Long-Term Incentive Awards (LTIs). The elements, described in more detail below, are generally intended to guarantee executives a base annual salary with potentially significant

[12] Fannie Mae used Freddie Mac in its comparable group, and Freddie Mac used Fannie Mae in its comparable group.

increases in compensation on a deferred basis provided the pre-established corporate financial and operational performance targets are met.

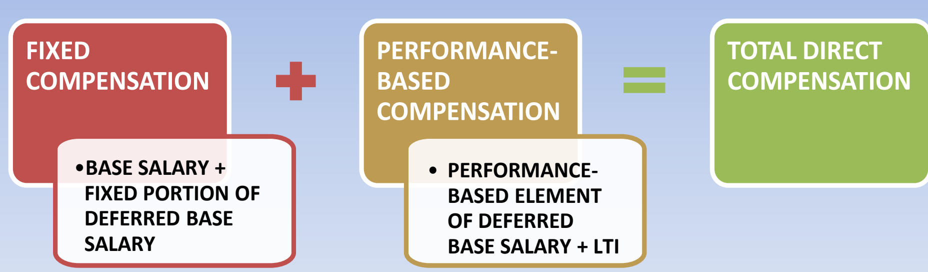
Base Salary: Base salary is tied to the responsibility level of the senior executive, and is intended to provide the senior executive with a fixed level of compensation commensurate with his or her responsibilities. Base salary cannot exceed $500,000 per year, except for each Enterprise's CEO, COO, and CFO, whose salaries have ranged from about $600,000 to $900,000 in 2009 and 2010. All other senior executives who were employed at the Enterprises immediately prior to the adoption of their new executive compensation plans had their salaries adjusted down to the $500,000 limit, effective January 1, 2010.

Deferred Base Salary: Deferred base salary is a separate salary component. It consists of two elements: a fixed portion and a performance-based portion. Payments of such salary are deferred for up to 15 months from the end of the calendar year upon which the executive's performance is being rated (*e.g.*, for calendar year 2009, the deferred payments were to be made by March 15, 2011), and executives forfeit the deferred compensation if they leave the Enterprises prior to payment. FHFA officials have stated that deferring payments for one year is designed to aid in executive retention, which is a major objective of the Enterprises' executive compensation plans.

Long-Term Incentive Awards (LTIs): LTIs are designed to provide the Enterprises' senior executives with incentives to meet specific corporate and individual performance measures over the long-term, as well as to remain with the Enterprises for extended periods. LTI payments must be approved by each Enterprise's compensation committee and by FHFA. As with deferred base salary, LTI payments are to be made no later than March 15 of the year following the year to which the annual performance measures are applicable.

The three salary elements above are combined to form what is known as each executive's "total direct compensation." An Enterprise executive's total direct compensation is calculated, in simplified form, as shown in Figure 1.

Figure 1: Process by Which Enterprises' Executives Total Compensation Levels are Calculated



Source: FHFA testimony and Fannie Mae and Freddie Mac 10-Ks

3. The Enterprises' Executive Performance Plans Are Structured to Mitigate Some Potentially Problematic Compensation Practices

FHFA officials have stated that the Enterprises' executive compensation packages include provisions intended to address some of the problematic issues historically associated with corporate executive compensation programs. According to a federal panel that recently looked at the issue, corporate executive compensation programs frequently provided incentives for financial services company executives to undertake excessively risky business strategies, to the ultimate detriment of their companies.[13] Similarly, FHFA's predecessor found that the Enterprises' historical executive compensation plans encouraged their executives to undertake business strategies that allegedly manipulated the Enterprises' financial statements.[14] In addition to rewarding executives on the upside for high-risk behaviors, some executive compensation packages also had significant downside protections, *e.g.*, "**golden parachute**" severance packages. Such packages were awarded to departing executives even in situations when their activities led to the insolvency of their companies.

> ***Golden parachute*** *is the term used for special compensation arrangements, such as, cash, a special bonus, stock options or vesting of previously awarded compensation, between a company and its senior executives in case the company is acquired or if an individual is fired or involuntarily separated. See generally http://lexicon.ft.com/Term?term=golden-parachute*

FHFA officials have stated that the Enterprises' executive compensation packages address such concerns by:

- Being entirely cash-based. FHFA officials have acknowledged that the packages are cash-based because the value of their common stock is essentially zero;
- Requiring FHFA approval of the use of severance or "golden parachute" provisions, thereby mitigating the possibility that Enterprise executives could leave with large payouts even if the companies' financial conditions deteriorate; and
- Containing "clawback" provisions under which executives' salary and deferred compensation can be recovered in the event of gross misconduct, gross negligence, conviction of a felony, or erroneous performance metrics.

FHFA officials also have cited other beneficial aspects of the Enterprises' executive compensation packages, such as limits on retirement formula calculations and expense reimbursements.

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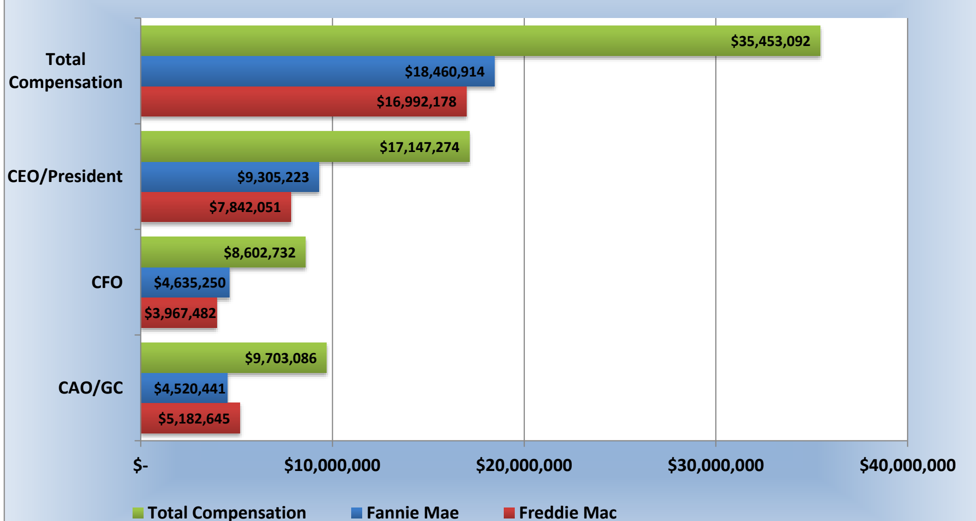
[13] "The Financial Crisis Inquiry Report," Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 27, 2011, available at http://www.fcic.gov/report.

[14] Office of Federal Housing Enterprise Oversight (OFHEO), Report of the Special Examination of Freddie Mac, December 2003, available at http://www.fhfa.gov/webfiles/749/specialreport122003.pdf; and OFHEO, Report of Special Examination of Fannie Mae, May 2006, available at http://www.fanniemae.com/media/pdf/newsreleases/FNMSPECIALEXAM.pdf.

4. <u>The Enterprises' Total Executive Compensation in 2009 and 2010 Was Substantial</u>

According to FHFA's Acting Director, the Enterprises' executive compensation packages for 2009 and 2010 set annual total compensation targets of $6 million for the Enterprises' CEOs, $3.5 million for the CFOs, and less than $3 million for Executive Vice Presidents and below. These annual targeted compensation amounts will remain in place indefinitely, unless they are modified by FHFA. Figure 2 shows that the approved compensation for the top six executives at Fannie Mae and Freddie Mac for 2009 and 2010 totaled more than $35.4 million. (Appendix A shows a more detailed breakdown of that amount.) The Enterprises' two CEOs received approximately half ($17 million) of the $35.4 million. However, had the CEOs met their targeted total compensation levels, which they did not, they would have received an additional $7 million. In other words, they could have been paid as much as $24 million over two years, an extraordinary sum.[15]

Figure 2: Total Compensation of Top Six Senior Officers at Enterprises in 2009 and 2010



Source: Fannie Mae and Freddie Mac 2009 and 2010 10-Ks

FHFA's Acting Director has acknowledged that executive compensation levels under the compensation packages are significant, but noted that they are substantially lower than they were before the conservatorships began. According to the Acting Director, the Enterprises' overall executive compensation matches their pre-2000 levels, and are 40 percent below the levels at which they were paid shortly before the conservatorships were established in September 2008.

The Acting Director regards the executives' compensation levels as reasonable given the progress that the Enterprises have made while in conservatorships. For example, in February 2010, the Acting Director testified that both Enterprises made progress in 2009 in terms of their loss mitigation efforts and achievement of reductions in credit losses.

[15] The annual targeted compensation for each CEO is $6 million annually or $12 million per year. Thus, the total targeted compensation for both CEOs for 2009 and 2010 was $24 million.

FINDINGS

In conducting this evaluation, FHFA-OIG found that FHFA: (1) has not reviewed issues necessary to determine whether the approved compensation packages for the Enterprises' executives in 2009 are reasonable and whether compensation is sufficient to recruit and retain key professionals; (2) lacks key controls necessary to monitor the Enterprises' ongoing compensation decisions under their approved packages; and (3) does not provide sufficient transparency to the public of the Enterprises' executive compensation programs.

1. FHFA Has Addressed Some High-Risk Enterprise Pay Issues, but Has Not Reviewed Key Issues to Determine Whether Compensation Levels Are Reasonable and Meet Enterprise Requirements

Although FHFA has considered a number of factors in developing the Enterprises' compensation packages, compensation remains a key management and risk area. The more than $35 million in total compensation awarded to the Enterprises' top six officers in 2009 and 2010, as well as the prospects of continuing such compensation levels going forward, is likely to raise concerns from members of Congress and the public, especially given the level of taxpayer support for the Enterprises. Further, compensation is subject to frequent changes based upon evolving economic and policy issues that affect the housing markets and the operation of the Enterprises. Accordingly, FHFA-OIG recommends that the Enterprises' executive compensation levels should be subject to ongoing Agency review and analysis.

In this regard, the FHFA-OIG has identified the following matters as meriting FHFA's review of the Enterprises' current executive compensation levels:[16] the disparity with compensation at federal housing entities, the impact of federal assistance, and recruitment and retention challenges.

A. <u>The Disparity in Compensation Between the Enterprises' Executives and Senior Executives at Federal Entities that Are Providing Critical Support to the Housing Finance System, *i.e.*, FHFA, Ginnie Mae and FHA</u>

Although the executives at the Enterprises have far more generous compensation packages than the executives at FHFA, Ginnie Mae, and FHA, FHFA has not conducted a comparability analysis that takes these differences into account.[17] While such comparability analyses are a common means of establishing

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[16] On the basis of documents provided by FHFA, and FHFA-OIG staff discussions with Agency officials, the FHFA-OIG concludes that these issues were not fully considered in 2008 and 2009, during the development of the Enterprises' executive compensation packages.

[17] As discussed earlier, the Enterprises' consultants did assist them in identifying comparable groups in developing their compensation plans. These comparable groups included large banks and insurance companies, as well as the Enterprises' themselves, but not FHA, FHFA, or Ginnie Mae.

compensation levels, an FHFA official stated that the Agency never seriously considered comparing the Enterprises' compensation to compensation at FHFA, FHA, and Ginnie Mae. The official also stated that there are key differences between the organizations, including their relative sizes and the complexity of their operations. He noted that, for example, Ginnie Mae is a "pass-through" organization that simply guarantees MBS issued by lenders and securitizers and is not responsible for credit risk management, which is the job of FHA. In contrast, he stated that the Enterprises issue MBS and are responsible for credit risk management.

Although there may be key differences between the Enterprises and FHA, FHFA, and Ginnie Mae, it is also the case that FHA, FHFA, and Ginnie Mae play key roles in the mortgage finance system, and that their senior officials make far less in compensation than the Enterprises' executives. For example, Ginnie Mae financed 29 percent of all newly-issued MBS in the third quarter of 2010, which is approximately the same amount as Freddie Mac. Yet, HUD reports the President of Ginnie Mae's compensation is less than $200,000 annually. FHFA-OIG does not take a position as to whether compensation levels should be comparable among the Enterprises' executives and those of FHFA, FHA, and Ginnie Mae, but believes that FHFA should formally review the current situation to account for the disparate levels of compensation and render this issue transparent to Congress and members of the public.

B. <u>The Extent to Which Federal Support of the Enterprises May Facilitate Their Capacity to Meet Performance Targets and, By Extension, the Ability of Their Executives to Achieve Higher Levels of Compensation That May Not Be Warranted</u>

Since the Enterprises have been in conservatorships, Treasury has invested more than $153 billion to maintain their stability and solvency. Further, in November 2008, the Federal Reserve announced that it would purchase up to $1.25 trillion in the Enterprises' MBS. Under this program, the Federal Reserve purchased essentially all of the Enterprises' net MBS issuances in 2009.

In 2009, executive compensation at Fannie Mae was based on, among other things, whether Fannie Mae was able to issue at least 37.5 percent of all new MBS issues. Fannie Mae's 2009 **Form 10-K** stated that it had exceeded its annual corporate performance goal of issuing 37.5 percent of all new MBS issuances by issuing 47 percent. It seems unlikely that Fannie Mae could have commanded such a large share of the market without the Federal Reserve's purchases of its MBS.

The annual report on ***Form 10-K*** *provides a comprehensive overview of the company's business and financial condition and includes audited financial statements. Although similarly named, the annual report on Form 10-K is distinct from the "annual report to shareholders," which a company must send to its shareholders when it holds an annual meeting to elect directors. See* *http://www.sec.gov/answers/form10k.htm*

Given the massive federal support, FHFA-OIG believes that FHFA should assess such instances and determine whether discounts to the executives' compensation should be applied as appropriate to compensate for executive performance data that may be overstated because of federal assistance.

C. The Potential Challenges in Recruiting and Retaining Key Technical Expertise

FHFA's Acting Director has stated that recruitment and retention are key concerns given the Enterprises' uncertain future, especially given the Administration's recent proposal calling for the wind down of the Enterprises. Under the circumstances, the potential exists that key Enterprise professionals, such as specialists in MBS issuances or credit risk management, information technology, and accounting could be difficult to recruit and retain. FHFA officials have stated that the Enterprises are actively considering recruitment and retention issues, including whether their existing compensation packages are sufficient to attract and keep key technical personnel. FHFA anticipates that the Enterprises will complete these reviews over the next several months.

FHFA should consider developing objective metrics with which to analyze the data produced by the Enterprises, and thereby gain a better understanding of their recruitment and retention issues. This would put the Agency in a position to provide more meaningful oversight of the Enterprises' decision-making processes, as well as their implementation of any compensation-based strategies designed to address their recruitment and retention issues.

2. FHFA Lacks a Number of Key Controls Necessary to Ensure the Effectiveness of Its Ongoing Enterprise Executive Compensation Oversight Processes

FHFA established the Enterprises' overall compensation packages in 2009, and it has an ongoing oversight responsibility to ensure that annual compensation decisions made pursuant to the packages are appropriate. The Enterprises' executives' actual total direct compensation each year depends largely upon their performance in meeting pre-established financial and performance targets. Absent a rigorous and credible corporate performance measurement process, FHFA would not be well-positioned to provide assurance that the compensation being paid to executives at the Enterprises each year is justified. In that regard, FHFA-OIG determined that the Agency's oversight processes lack a number of key controls necessary to help ensure their effectiveness, such as:

- Written evaluation criteria;
- Testing and verification procedures; and
- Documentation standards.

FHFA officials have reported that the Agency plans to establish new oversight procedures for executive compensation, which is a positive development. However, these procedures, as described to FHFA-OIG, do not address all the limitations FHFA-OIG has identified.

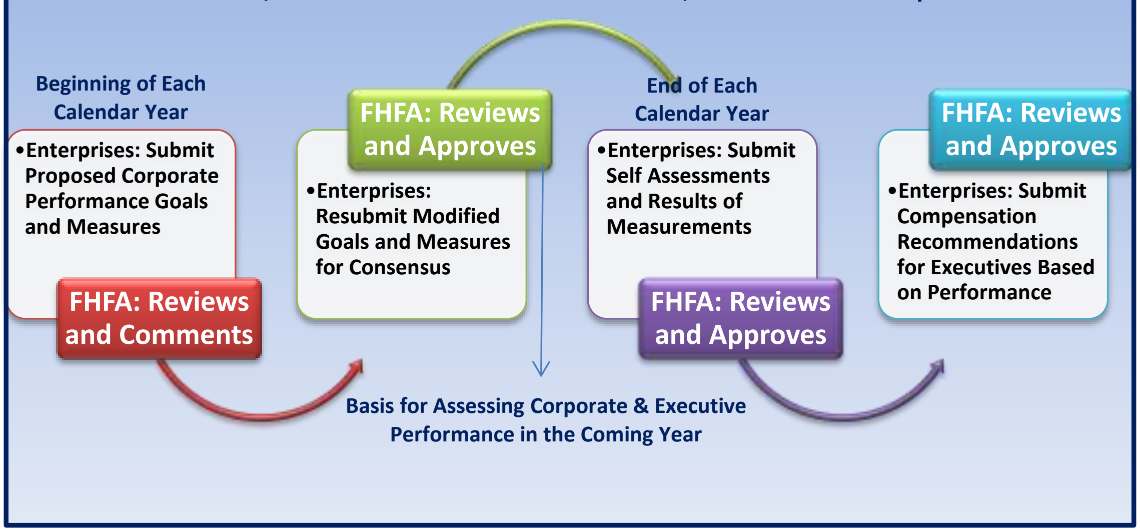
A. <u>FHFA Has Not Adopted Standard Evaluation Criteria Under Which to Review the Enterprises' Proposed Corporate Performance Goals, or Their Performance Against Those Goals</u>

The total compensation that the Enterprises' executives are to receive each year is based largely upon their performance in meeting pre-established financial and performance targets, such as reducing credit-related losses. As such, it is critical that FHFA develop a credible process for monitoring the Enterprises' development of various performance goals, as well as measuring their performance against those same goals.

Figure 3, below, summarizes FHFA's processes for reviewing and approving corporate performance, as well as determining executive compensation levels.

1) In advance of each calendar year, the Enterprises submit to FHFA for its review and approval the Enterprises' proposed corporate performance goals and measures. Several offices within FHFA, including the OCO, the OPAR, and the Division of Enterprise Regulation (DER), review the proposed performance goals and measures. These offices examine the performance goals and measures only at the Enterprise level; they do not review them at the senior executive level. In other words, FHFA determines what will be the overall performance goals and total compensation pools of the Enterprises, and then delegates to the Enterprises decision-making authority regarding which executives are responsible for achieving such goals and what the total compensation for each such executive will be, subject to statutory limitations.

Figure 3: FHFA's Process for Reviewing and Approving the Enterprises' Proposed Performance Goals and Measures, Self-Assessment Performance Data, and Executive Compensation Levels



FHFA lacks agency-wide or uniform documented procedures for the OCO, the OPAR, and the DER to review and approve the proposed corporate performance goals and measures. Owing to the dearth of records documenting the individual offices' reviews, FHFA-OIG cannot opine concerning: (i) precisely what review processes the individual FHFA offices employed; (ii) whether these offices employed consistent processes; or (iii) whether the processes employed are effective.

Once these FHFA offices approve the goals and measures, the Enterprises' board of directors must also approve them, and they become the basis for assessing corporate and executive performance for the coming year.

2) At the end of the calendar year, the Enterprises submit self-assessments to FHFA in which they provide data concerning how they performed against the corporate goals established for the year. Similar to the practices employed when the OCO, the OPAR, and the DER review and approve performance goals and measures, these offices analyze successful achievement of the established goals at the Enterprise level only. Additionally, these offices have no agency-wide or uniform documented procedures for analyzing achievement of the goals. Accordingly, like with FHFA's process for setting performance goals and measures, FHFA-OIG was unable to assess the efficacy of FHFA's analysis of goal achievement.

   Once FHFA approves the performance data, the Enterprises' boards of directors also must approve.

FHFA has established various procedures to review the Enterprises' corporate performance on an annual basis. However, as described above, certain management and internal controls necessary to help ensure the integrity of these processes are lacking. According to the Government Accountability Office (GAO) and the Office of Management and Budget (OMB), establishing and documenting management procedures is a key means by which to ensure that responsibilities are being carried-out and objectives attained.[18] FHFA, however, has not developed substantive, written criteria for either evaluating the Enterprises' proposed corporate performance goals (at the start of each calendar year) or their self-assessments of their success in achieving these goals (at year-end).

Moreover, given that FHFA's internal practices are not documented, FHFA-OIG is unable to gauge whether sufficient internal controls exist. For example, FHFA has not established content requirements for the Enterprises' annual submissions. This could result in, among other things, variances in the contents of the Enterprises' submissions.

The lack of standardized evaluation criteria, documentation of management procedures, and internal controls therefore renders FHFA unable to demonstrate that its oversight of Enterprise executive compensation is effective, consistent, and reliable.

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[18] *See* GAO, Standards for Internal Control in the Federal Government, GAO/AIMD-00.21.3.1 (Washington, D.C., November 1999) and Office of Management and Budget, Management's Responsibility for Internal Control, OMB Circular No. A-123 Revised, Appendix A, "Internal Control Over Financial Reporting" (Washington, D.C., December 2004). *See also* United States Government Accountability Office, *Securities and Exchange Commission: Additional Actions Needed to Ensure Planned Improvements and Address Limitations in Enforcement Division Operations*, GAO-07-830 (August 2007), http://www.gao.gov/new.items/d07830.pdf.

B. FHFA's Reviews of the Enterprises' Recommended Compensation Levels for Individual Executives are Limited, Lack Written Criteria, and Do Not Include Testing and Verification

After FHFA approves the Enterprises' performance self-assessments at the end of each calendar year, the Enterprises submit for review compensation data for individual executives. The OCO, the OPAR, and the DER then review the compensation data at the senior executive level. According to FHFA officials, the Agency's review of the Enterprises' proposed individual executive compensation levels is limited. In general, FHFA delegates to the Enterprises, through their compensation committees and boards of directors, responsibility for determining the appropriate compensation for each executive, and accepts their proposed recommendations unless there is an observed reason to do otherwise. FHFA officials have stated that the OCO, the OPAR, and the DER focus their attention on those cases in which a proposed compensation recommendation is "aberrant" or an "outlier," *i.e.*, very high or very low as compared to compensation proposals made in the comparable financial firms listed in the affected Enterprises' Forms 10-K. FHFA officials have further stated that they give special attention to compensation proposals that are inconsistent with the Agency's experience with a particular executive.

As is the case with FHFA's annual reviews of the Enterprises' proposed corporate measures and self-assessment data, FHFA has not adopted standard criteria by which to evaluate individual executive compensation proposals. Thus, FHFA cannot, among other things, ensure the consistency of such annual reviews.

Moreover, FHFA's practice of accepting the Enterprises' recommended compensation levels, unless they are "aberrations" or "outliers," is inconsistent with commonly accepted examination and auditing procedures that call for testing and verification of key decisions. Absent such testing and verification, FHFA lacks an empirical basis for concluding that the Enterprises are accurately and appropriately fixing their executives' compensation levels. Specifically, FHFA does not:

- Verify executives' performance ratings;
- Reconstruct how an Enterprise calculated a recommended compensation level; or
- Determine whether such calculations were made in accordance with established policies and procedures.

Further, the lack of testing and verification does not provide a reasonable basis for outside observers, such as FHFA-OIG, Congress, or taxpayers to be assured that the Enterprises are, in fact, making individual compensation decisions consistent with policies and procedures.

C. FHFA's Executive Documentation Policies and Procedures Are Inadequate

FHFA has not established procedures to ensure that key compensation documents are stored on a consistent basis and readily available to relevant Agency officials and staff. For example, an FHFA official has stated that, due to constrained personnel resources, many compensation documents remain largely inaccessible in his office awaiting electronic filing. In another case, FHFA-OIG's request for documents related to FHFA's review and approval process was met by an Agency official's instruction to an OPAR employee to download the requested material from the official's FHFA email account, which is not available to other Agency staff on an ongoing basis. Without the means to file key documents in a consistent manner and, thereby make them readily accessible to Agency officials, FHFA's ability to execute its compensation oversight functions is significantly decreased.

D. FHFA's Planned Policy Revisions May Not Be Sufficient

Shortly before this evaluation concluded in March 2011, an Agency official stated that new procedures were being developed for executive compensation oversight. These procedures would reportedly establish a consistent basis for reviewing the Enterprises' proposed corporate performance goals and self-assessment data. FHFA also is in the process of recruiting two professionals to enhance its executive compensation oversight processes. Although these initiatives are positive developments, the procedures' final form remains to be seen. Moreover, as described to FHFA-OIG staff, the new procedures would not address at least one key limitation in the Agency's procedures. Specifically, the proposed procedures do not include testing and verification of the Enterprises' recommended executive compensation levels.

3. FHFA Does Not Provide Sufficient Transparency to the Public of the Enterprises' Executive Compensation Programs

A key principle associated with reforms to executive compensation is that the terms of such compensation must be transparent to shareholders and others. For example, in June 2009, Treasury Secretary Timothy Geithner set forth five broad-based principles that are intended to guide corporations in setting the rates at which their executives are compensated.[19] The fifth principle is the promotion of transparency and accountability in the process of setting executive compensation. In discussing this principle, Secretary Geithner noted that "many of the compensation practices that encourage excessive risk-taking might have been more closely scrutinized if compensation committees had greater independence and shareholders had more clarity." Moreover, Members of Congress have requested that the Enterprises enhance transparency in terms of their executive compensation practices and have introduced legislation designed to bring about this result.[20]

Implementing the recommendations discussed previously in this evaluation would make the Enterprises' executive compensation practices more transparent. Specifically, conducting a formal analysis of the significant differences in compensation among the Enterprises, FHFA, FHA, and Ginnie Mae and whether they are warranted, might assist FHFA in articulating the basis for the Enterprises' executive compensation levels, as well as making any adjustments that may be warranted. Further, strengthening the processes and

[19] *See* Http://www.treasury.gov/press-center/press-releases/Pages/tg163.aspx.

[20] House Financial Services Committee hearing, February 25, 2010.

procedures by which it oversees the setting of the Enterprises' executive compensation packages could enhance FHFA's capacity to provide assurances that such compensation is reasonable and justified.

FHFA also could take reasonable steps to enhance the availability of user-friendly information that is available to the public about the Enterprises' corporate performance and executive compensation. The Enterprises' 10-Ks contain considerable information about Enterprise performance goals, self-assessment data, and executive compensation, and FHFA officials have claimed that such information is sufficient. However, FHFA does not direct users of its website to the 10-K filings for performance and compensation information. Further, the 10-K filings can be detailed and complex and they do not include trend data.

Accordingly, FHFA-OIG believes that FHFA should provide accessible and user-friendly executive compensation information on its website, including:

- Links that specifically direct users to the Enterprises' SEC filings for further information regarding their performance and executive compensation issues;
- Trend data showing how the Enterprises are performing in meeting key performance measures over time;
- Trend data showing executive compensation levels and whether such compensation is in line with the Enterprises' performance; and
- Analyses that demonstrates the reasonableness of the compensation being paid to the Enterprises' senior executives.

CONCLUSIONS

In developing the Enterprises' compensation packages, FHFA, to its credit, has consulted with key experts such as the Treasury Special Master for TARP Executive Compensation. FHFA also ensured the packages were performance-based and addressed concerns about problematic executive pay practices, such as "golden parachute" severance packages. However, given the government's significant financial commitments to the Enterprises and the potential for significant additional taxpayer losses, multi-million dollar compensation packages paid to the Enterprises' executives will likely continue to generate significant controversy.

Accordingly, FHFA has an ongoing responsibility to review and analyze these packages carefully and continuously; and to ensure that they are, in fact, reasonable, intellectually defensible and economically appropriate. Further, FHFA has an obligation to develop a credible oversight process to ensure that annual compensation decisions made pursuant to the packages are appropriate, and to take reasonable steps to enhance transparency about the Enterprises' performance and executive compensation levels.

RECOMMENDATIONS

To provide assurance that the Enterprises' executive compensation levels are reasonable and appropriate, we recommend that FHFA establish an ongoing process of review and analysis that includes the following factors:

1. The disparity in compensation between the Enterprises' executives and the senior executives at federal entities that are providing critical support to the housing finance system, *i.e.*, Ginnie Mae, FHFA, and FHA;
2. The extent to which federal financial support for the Enterprises may facilitate their capacity to meet certain performance targets and, by extension, the capacity of their executives to achieve high levels of compensation that may not be warranted; and
3. The potential challenges the Enterprises might face in recruiting and retaining technical expertise, which might include the employment of objective metrics to assess these issues and the extent to which existing compensation levels may need to be revised.

To strengthen its oversight of the Enterprises' ongoing executive compensation policies and practices pursuant to the compensation packages, FHFA should:

1. Establish written criteria and procedures for reviewing the Enterprises' annual performance measures and year-end performance assessment data, as well as their recommended executive compensation levels;
2. Conduct independent testing and verification, perhaps on a randomized basis, to gain assurance that the Enterprises' bases for developing recommended individual executive compensation levels is reasonable and justified; and
3. Create and implement policies to ensure that all key executive compensation documents are stored consistently and remain readily accessible to appropriate Agency officials and staff.

To enhance transparency associated with the Enterprises' conservatorships and executive compensation, FHFA should:

1. Post on its Internet website summarized information about the Enterprises' executive compensation packages, the Enterprises corporate performance goals and performance against those goals, executive compensation levels, and related trend data; and
2. Establish links in these Internet website postings to SEC filings and other relevant information.

FHFA COMMENTS AND FHFA-OIG'S RESPONSE

FHFA-OIG provided a draft of this evaluation to FHFA for its review and comment. On March 29, 2011, FHFA's Chief Economist provided the Agency's written comments, which are published verbatim in Appendix B. FHFA agreed to:

1. Study how federal support for the Enterprises and their conservatorship status may facilitate their capacity to meet certain performance goals;

2. Institute a practice of regularly monitoring and evaluating metrics associated with recruitment and retention of employees and considering appropriate compensation levels;

3. Establish a formal and systematic approach for reviewing the Enterprises' performance measures and self-assessment data;

4. Strengthen its executive compensation document storage systems; and

5. Consider options for improving the transparency of the Enterprises' executive compensation programs, including establishing links to their securities filings on FHFA's website.

FHFA did not agree, however, with FHFA-OIG's recommendations to: (1) assess disparities in compensation among senior officials of the Enterprises and of FHFA, FHA, and Ginnie Mae; and (2) test and verify the Enterprises' annual salary recommendations for their senior executives.

In its written comments, FHFA stated that private sector compensation scales are the most useful comparables given the size and complexity of the Enterprises' activities. FHFA added that no government agency comes close to being able to manage the Enterprises' varying activities without relying on private contractors (FHFA-OIG questions the validity of this assertion, given that the Enterprises rely heavily on a wide spectrum of private sector contractors and consultants), and, therefore, government pay levels are not useful benchmarks by which to evaluate the Enterprises' pay levels.

FHFA-OIG noted the distinctions between the Enterprises and the three federal agencies in the draft evaluation report. FHFA-OIG also has indicated, however, that FHFA's exclusive reliance upon private sector salary comparisons fails to take into account the critical distinction between the Enterprises and other companies, *e.g.*, the $153 billion in federal funds and other federal assistance that the Enterprises have received to date, and the unique advantage that federal assistance may provide their executives in meeting their individual performance goals. Accordingly, FHFA-OIG continues to believe that FHFA should conduct a formal comparability analysis between the Enterprises and the three federal agencies involved in the mortgage market in order to arrive at appropriate levels of executive compensation. Additionally, such an analysis would enhance transparency regarding such compensation.

Although FHFA stated that testing of the Enterprises' corporate performance goals is desirable, and processes are in place to do so, the Agency also noted that it does not conduct such testing of recommended compensation for individual executives. FHFA stated that it relies on the Enterprises' boards of directors and senior management to establish such compensation levels. FHFA added that it reviews the results for reasonableness and has requested reconsideration in some instances.

As stated in the report, FHFA's policy of not testing and verifying recommended individual compensation levels is not fully consistent with examination and auditing standards, which require a degree of professional skepticism in evaluating the activities of regulated entities. Absent such testing, FHFA lacks an empirical basis for concluding that the Enterprises are appropriately setting executive compensation levels. Similarly, FHFA's lack of verification does not provide a reasonable basis for outside observers, such as FHFA-OIG, Congress, and taxpayers to be assured that the Enterprises are, in fact, making compensation decisions consistent with policies and procedures.

APPENDIX A: ENTERPRISES' TOTAL DIRECT COMPENSATION

Total Direct Compensation of Top Six Executives
Fannie Mae and Freddie Mac, Calendar Years 2009 and 2010

	Base Salary Rate		Deferred Pay		Long-Term Incentive Awards		Total Compensation Paid
	2009	2010	2009	2010	2009	2010	2009 & 2010
Fannie Mae							
CEO/President	$ 860,523	$ 900,000	$ 2,867,200	$ 2,945,000	$ 832,500	$ 900,000	$ 9,305,223
CFO	675,000	425,000	1,700,000	992,750	517,500	325,000	4,635,250
CAO/GC	439,346	500,000	1,278,610	1,396,184	421,301	485,000	4,520,441
Total	**$ 1,974,869**	**$ 1,825,000**	**$ 5,845,810**	**$ 5,333,934**	**$ 1,771,301**	**$ 1,710,000**	**$ 18,460,914**
Freddie Mac							
CEO	$ 1,084,435	$ 900,000	$ 1,227,083	$ 2,912,450	$ 395,833	$ 1,322,250	$ 7,842,051
CFO	259,343	675,000	370,999	1,558,005	428,002	676,133	3,967,482
GC/Secretary	600,000	500,000	1,260,000	1,277,720	663,750	881,175	5,182,645
Total	**$ 1,943,778**	**$ 2,075,000**	**$ 2,858,082**	**$ 5,748,175**	**$ 1,487,585**	**$ 2,879,558**	**$ 16,992,178**
Total - Enterprises	**$ 3,918,647**	**$ 3,900,000**	**$ 8,703,892**	**$11,082,109**	**$ 3,258,886**	**$ 4,589,558**	**$ 35,453,092**

Source: Fannie Mae and Freddie Mac 2009 and 2010 SEC 10-K Filings.

APPENDIX B: MANAGEMENT COMMENTS TO THE DRAFT REPORT

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Acting Deputy Inspector General for Evaluations

FROM: Patrick Lawler, Senior Associate Director and Chief Economist, Office of Policy Analysis & Research

SUBJECT: Evaluation of Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs (Evaluation Report: EVL-2011-002)

DATE: March 29, 2011

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses for the recommendations resulting from the evaluation performed by your staff from January 2011 to March 2011. As stated in report, the purpose of the evaluation was to assess FHFA's development and oversight of the executive compensation programs for Fannie Mae and Freddie Mac.

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

Recommendation 1: To provide assurance that the Enterprises' executives' compensation levels are reasonable and appropriate, we recommend that FHFA establish an ongoing process of review and analysis that includes the following factors:

1. The disparity in compensation between the Enterprises' executives and the senior executives at federal entities that are providing critical support to the housing finance system, i.e., Ginnie Mae, FHFA, and FHA;
2. The extent to which federal financial support for the Enterprises may facilitate their capacity to meet certain performance targets and, by extension, the capacity of their executives to achieve high levels of compensation that may not be warranted; and
3. The potential challenges the Enterprises might face in recruiting and retaining technical expertise, which might include the employment of objective metrics to assess these issues and the extent to which existing compensation levels may need to be revised.

Management Response: We have been supervising quite closely Enterprise pay to their senior executives. Before the Conservatorships, our responsibility was to prohibit compensation of these officers that was not reasonable and comparable to pay for positions with similar duties at similar businesses. We hired external experts to provide extensive information about comparability, to ensure that Enterprise pay was consistent with the market. When the conservatorships were established, we again sought external assistance to help us design temporary pay structures designed to retain the expertise needed by the Enterprise to allow them to play an essential role in preventing a more serious collapse of housing markets than what occurred. We then worked with the Special Master of executive compensation at the Treasury Department and the Enterprises to design a new pay structure that provides enough to retain and recruit talent, while minimizing the cost to taxpayers. The new structures paid an average of 40 percent less than had been the standard pre-conservatorship. Since then the Enterprises have, in several cases, replaced a high-priced executive with one or more lower priced employees, at considerable savings. We continue to review the comparability estimates of consultants hired by the Enterprises and their compensation committees. And we also review comparability data that we have purchased independently.

We are well aware of the differences in pay scales at private firms and at government agencies. Fannie Mae and Freddie Mac were chartered by Congress as private sector firms with a public mission. Our job as conservator requires us to maintain their existing structure. Doing so maximizes the potential for taxpayers to realize some benefit from the asset value of the organizational structures and preserves for Congress a wider range of alternatives in designing new secondary market institutions. More importantly, we believe that employing the level of talent available at private sector pay scales is the most efficient way to provide the mortgage market services that are required. No existing government agency comes close to being able, without relying mainly on private sector contractors, to manage a $5.5 trillion mortgage credit portfolio, interest rate risk on $1.5 trillion, simultaneously maintain the structures to handle roughly 70 percent of all new mortgages and deal with serious delinquencies on an unprecedented scale. Accordingly, we do not believe that government pay levels are useful benchmarks for evaluating Enterprise pay and therefore disagree with including them as a factor in the compensation analysis.

We agree that in evaluating an Enterprise's performance against their targets, some types of targets are easier for the Enterprises to meet than they would be for private firms. As we develop more systematic procedures for review of Enterprise performance against goals (see below), we will include in those procedures consideration of the effect, if any, of the Enterprise's GSE and conservatorship status in evaluating the appropriateness of specific goals and performance against goals when that performance is facilitated by that status.

We also agree that metrics associated with retention and recruitment of employees are relevant in considering the appropriateness of pay levels. We receive frequent reports of such measures from the Enterprises, but we agree that a more systematic review is desirable and we plan to institute a practice of regular monitoring and evaluation of such data.

Recommendation 2: To strengthen its oversight of the Enterprises' ongoing executive compensation policies and practices pursuant to the compensation packages, FHFA should:

1. Establish written criteria and procedures for reviewing the Enterprises' annual performance measures and year-end performance assessment data, as well as their recommended executive compensation levels;
2. Conduct independent testing and verification, perhaps on a randomized basis, to gain assurance that the Enterprises' bases for developing recommended individual executive compensation levels is reasonable and justified; and
3. Create and implement policies to ensure that all key executive compensation documents are stored consistently and remain readily accessible to appropriate Agency officials and staff.

Management Response: We agree that we should institute a more formal and systematic approach to our reviews of each Enterprise's internal scorecards and their evaluations of their performance against those scorecards at the end of the year. We have performed such reviews with considerable care, discussing both the scorecards and performance evaluations with the Enterprises and their Boards, and we have included all relevant internal offices in our reviews. Nonetheless, we agree that it is important to develop clear written procedures that will help ensure a consistent and thorough process.

We agree that independent testing of Enterprise performance against its goals is desirable. We believe existing processes exist, through the Enterprises' internal audit functions and FHFA's supervisory examination process. Specifically, we have relied on each Enterprise's internal audit function to review reported results for either or both of the past two years. Those functions are independent because we have required that their pay is not affected by performance on the general corporate metrics. We also consult with our exam team to determine whether they find the reports reasonable. We do not, however, evaluate individual employees. We leave that to the Boards of Directors and senior management that we have hired to do this as a normal part of their jobs. We do review the results for reasonableness, and we have requested reconsideration in some instances.

We agree that we need to complete a transfer of document storage systems. Doing so will facilitate access to relevant documents for appropriate Agency officials.

Recommendation 3: To enhance transparency associated with the Enterprises' conservatorships and executive compensation, FHFA should:

1. Post on its Internet website summarized information about the Enterprises' executive compensation packages, the Enterprises corporate performance goals and performance against those goals, executive compensation levels, and related trend data; and
2. Establish links in these Internet website postings to SEC filings and other relevant information.

Management Response: We agree in principle with the recommendation to improve the transparency of executive compensation information and will consider our options to do so. We believe that current SEC disclosures provide excellent information about executive pay at the

Enterprises and we welcome review of that information by all interested members of the public. It includes detail about executive pay packages, Enterprise performance goals, and performance of the Enterprise and top management. While we have links on our website to EDGAR, the SEC's electronic warehouse of required disclosures, we recognize that may still leave access to the Enterprises' compensation and financial disclosures somewhat difficult for some users who are not familiar with EDGAR. We will consider whether and how we could make this information more accessible.

APPENDIX C: MAJOR CONTRIBUTORS TO THIS REPORT

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