

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

**White Paper: FHFA-OIG's Current
Assessment of FHFA's Conservatorships
of Fannie Mae and Freddie Mac**





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AT A GLANCE

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Background

In 2007 and 2008, as the residential housing market experienced a sharp decline, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) suffered billions of dollars in losses. In response to these losses and to stabilize the broader financial markets, the Housing and Economic Recovery Act of 2008 (HERA) was enacted on July 30, 2008. HERA, among other things, created the Federal Housing Finance Agency (FHFA or Agency) to assume the role of the Enterprises' safety, soundness, and housing mission regulator. HERA also provided a regime, if needed, to guide the Enterprises through insolvency. This regime includes authority for the U.S. Department of the Treasury (Treasury) to provide financial support to the Enterprises.

Less than six weeks later, on September 6, 2008, Fannie Mae and Freddie Mac entered conservatorships overseen by the Agency, and Treasury began to make substantial purchases of the Enterprises' senior preferred stock. As of December 31, 2011, Treasury has committed over \$183 billion to support the Enterprises.

Although they were expected to be temporary, the conservatorships have been in place for over three years, and there is no end in sight. FHFA estimates that, by the end of 2014, between \$220 and \$311 billion in financial support will have been drawn from the Treasury, and FHFA's Acting Director has stated that taxpayers are unlikely to be fully repaid for their support.

Scope

In this white paper, the FHFA Office of Inspector General (FHFA-OIG) provides background on the history of the Enterprises leading up to the creation of the conservatorships and describes their operations to date. It also includes an appendix that discusses pertinent issues raised in FHFA-OIG reports.

Summary

As the Enterprises' regulator and conservator, FHFA has considerable discretion in defining its role and choosing its actions. FHFA's role as conservator has evolved over time. At the outset of the conservatorships, FHFA forbade the Enterprises from engaging in certain activities and retained approval authority over others. Soon thereafter, FHFA delegated day-to-day operational decision-making to the Enterprises' directors and managers. Debate as to the proper parameters of the Agency's role as a conservator arose and continues. FHFA-OIG believes that FHFA needs to assume a more active role, and, thus, as discussed in Appendix A, FHFA-OIG's reports consistently have revealed two trends: (1) the Agency, in its role as a conservator, does not independently test and validate Enterprise decision-making; and (2) the Agency, in its role as a regulator, is not proactive in its oversight and enforcement. In addition, FHFA may not have enough examiners to meet its oversight responsibilities.

Additionally, FHFA faces significant challenges in managing the conservatorships of the Enterprises. These challenges include: (1) attempting to advance the Enterprises' business interests while assisting distressed homeowners; and (2) simultaneously serving as both the Enterprises' conservator and regulator.

As if these challenges were not daunting enough, the uncertain future of the Enterprises overshadows all aspects of FHFA's regulatory and conservatorship efforts. Although FHFA recently published a strategic plan for the next phase of the conservatorships (that focuses on building infrastructure for a private secondary mortgage market), the best method for resolving the Enterprises is dependent on many variables outside of FHFA's control. These variables include the health of housing finance markets, and debate about what the nation's mortgage finance system should look like. These variables are important to the American taxpayer, who has been financially supporting – and likely will continue to support – the Enterprises. Meanwhile, the practical issues of how FHFA should best manage the conservatorships need careful attention and oversight.

Table of Contents

Table of Contents	3
Abbreviations.....	5
Preface.....	6
Background.....	7
A. Evolving Federal Role in Housing Finance.....	7
B. The Enterprises’ Three Lines of Business.....	8
Single-Family	8
Multifamily.....	9
Investment and Capital Markets	9
C. Fannie Mae and Freddie Mac: 2000 – 2008	9
D. The Conservatorships	11
Conservatorships Established	11
Treasury’s Financial Support.....	12
Emergency Economic Stabilization Act of 2008	13
The Fragile U.S. Housing Market	14
Conservatorships in Operation.....	17
A. FHFA’s Duties and Responsibilities	17
FHFA’s Duties as Regulator Under HERA.....	17
FHFA’s Discretionary/Permissive Powers as Conservator Under HERA	18
FHFA’s Duties Under EESA.....	19
B. Treasury Agreements	19
C. FHFA’s Governance Milestones	20
Office of Conservatorship Operations	20
Conservatorships Governance Committee	21
FHFA’s Conservatorships Rule.....	21
D. Highlights of FHFA’s Conservatorships.....	22
FHFA’s General Approach to Conservatorships.....	22
Efficiency	23
Concordant Goals	23

Operational Savings.....	23
Specific Improvement Efforts	24
Foreclosure Prevention	24
Other Programs	24
Challenges Faced by FHFA.....	26
A. Unique Nature of the Conservatorships	26
B. Mission Tensions.....	28
C. Tension Between Roles as Regulator and as Conservator	30
D. An Uncertain Future	31
Conclusion.....	33
Scope and Methodology.....	34
Appendix A	35
Appendix B.....	41

Abbreviations

EESA.....	Emergency Economic Stabilization Act of 2008
Fannie Mae.....	Federal National Mortgage Association
FCIC.....	Farm Credit Insurance Corporation
FDIC	Federal Deposit Insurance Corporation
FHA.....	Federal Housing Administration
FHFA or Agency.....	Federal Housing Finance Agency
FHFA-OIG	Federal Housing Finance Agency, Office of Inspector General
FHLBank.....	Federal Home Loan Bank
Freddie Mac	Federal Home Loan Mortgage Corporation
GSE.....	Government-Sponsored Enterprise
HAMP.....	Home Affordable Modification Program
HARP	Home Affordable Refinance Program
HUD	U.S. Department of Housing and Urban Development
HERA.....	Housing and Economic Recovery Act of 2008
MBS	Mortgage-Backed Securities
NCUA	National Credit Union Administration
OCO	Office of Conservatorship Operations
OFHEO	Office of Federal Housing Enterprise Oversight
PSPAs	Senior Preferred Stock Purchase Agreements
Treasury	U.S. Department of the Treasury

Federal Housing Finance Agency

Office of Inspector General

Washington, DC

Preface

FHFA-OIG was established by HERA,¹ which amended the Inspector General Act of 1978.² FHFA-OIG is authorized to conduct audits, investigations, and other studies 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 white paper provides an overview of the operations of FHFA's conservatorships.

This white paper was written principally by Investigative Counsel Nicole R. Mark and Assistant Inspector General David M. Frost. It has been distributed to Congress, the Office of Management and Budget, and others and will be posted on FHFA-OIG's website, www.fhfaoig.gov.



George Grob
Deputy Inspector General for Evaluations

¹ Public Law No. 110-289.

² Public Law No. 95-452.

Background

Before the Great Depression of the 1930s, housing finance was exclusively the province of the private sector and generally consisted of short-term renewable loans.³ The features of these loans, which generally included high down payments (approximately half of the home's purchase price), short maturities (10 years or less), and large balloon payments, presented significant challenges to widespread home ownership.

Further, these pre-Depression era loans typically were funded locally by life insurers, commercial banks, and **thrifts**. In the absence of a nationwide housing finance market, availability and pricing for mortgage loans varied widely across the country.

Thrift

A financial institution that focuses on taking deposits and originating home mortgages. Thrift banks often have access to low-cost funding from Federal Home Loan Banks, which allows for higher savings account yields to customers and increased liquidity for mortgage loans.

A. Evolving Federal Role in Housing Finance

In response to the Depression era housing crisis, Fannie Mae was established in 1938 as a federal government agency.⁴ Its mandate was to act as a secondary mortgage market facility that could purchase, hold, and sell loans insured by the Federal Housing Administration (FHA). By purchasing these FHA-insured loans from private lenders, Fannie Mae provided lenders with cash to fund new home loans, thus injecting liquidity into the mortgage market.

In 1954, Fannie Mae was transformed from a government agency to a public-private, mixed ownership corporation.⁵ Later, in 1968, Fannie Mae was reorganized into a publicly-traded, for-profit, shareholder-owned company.⁶ As part of the reorganization, Fannie Mae was subjected to regulation by the U.S. Department of Housing and Urban Development (HUD).

In 1970, the secondary mortgage market was expanded with the establishment of Freddie Mac, which was intended to help thrifts manage challenges associated with interest rate risk.⁷

³ A more detailed description of the history of housing finance in the United States is available at: <http://www.fhfa.gov/Content/Files/History%20of%20the%20Government%20Sponsored%20Enterprises.pdf>. In addition, a diagram showing the evolving federal housing role is included as Appendix B to this white paper.

⁴ See The National Housing Act Amendments of 1938, Title II, 52 Stat. 8 (Feb. 3, 1938).

⁵ See Public Law No. 83-560.

⁶ See Public Law No. 90-448.

⁷ See Public Law No. 91-351.

Specifically, Freddie Mac purchased long-term mortgages from thrifts, increasing their capacity to fund additional mortgages and reducing their interest rate risk. The legislation that established Freddie Mac also authorized the Enterprises to buy and sell mortgages that were not insured or guaranteed by the government. Later in 1989, Freddie Mac was reorganized into a publicly-traded, for-profit corporation owned by private shareholders.⁸

Federal regulation of the Enterprises changed in 1992 with the creation of the Office of Federal Housing Enterprise Oversight (OFHEO), which was an independent regulator within HUD.⁹ OFHEO had the authority to conduct routine safety and soundness examinations of Fannie Mae and Freddie Mac and to take enforcement actions. The 1992 legislation that created OFHEO also amended Fannie Mae's and Freddie Mac's charters, requiring them to meet an "affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families." HUD was designated as the Enterprises' affordable housing mission regulator.

B. The Enterprises' Three Lines of Business

The Enterprises have three primary business lines: single-family; multifamily; and investment and capital markets.

Single-Family

In their single-family business line, the Enterprises buy single-family mortgages from mortgage companies, commercial banks, credit unions, and other financial institutions.¹⁰ They hold these mortgages in their investment portfolio or securitize them. Regarding securitization, the Enterprises bundle loans into mortgage-backed securities (MBS) that they, in turn, sell to investors.¹¹ When homeowners make their payments of mortgage principal and interest each month, these payments are ultimately transferred (passed-through) to securities investors.

Typically, the Enterprises receive a "guarantee fee" that is ultimately funded by investors. In exchange for this fee, the Enterprises guarantee the payment of principal and interest on their MBS. In the event that a homeowner stops making mortgage payments, the Enterprise that originated and guaranteed the subject MBS steps in and makes the payments to securities

⁸ Public Law No. 101-73.

⁹ Public Law No. 102-550.

¹⁰ Some lenders sell single-family mortgages outright to the Enterprises for cash, others exchange them for mortgage-backed securities. The cash price paid by an Enterprise depends on the required yield of the loan, which includes an implicit guarantee fee. Larger lenders primarily swap loans for mortgage-backed securities. Smaller lenders often choose to sell whole loans for cash because they lack the volume and capacity to utilize effectively the Enterprises' swap programs. See Fannie Mae and Freddie Mac G Fee Report Final.pdf, pp 4 and 10.

¹¹ Freddie Mac issued the first conventional MBS in 1971.

investors. The Enterprises set the guarantee fees to cover projected credit losses from borrower defaults over the life of the loans, administrative costs, and a return on capital.

In 2010, the Enterprises significantly increased their purchases of delinquent loans from single-family MBS trusts. This allowed the Enterprises to use their own lower cost debt to remove non-performing, high-interest loans from MBS that they had guaranteed. The Enterprises re-pay the investors for the balances of those non-performing loans and then place them in their own portfolios, thus realizing substantial cost savings. In 2011, Fannie Mae's average single-family guarantee book of business was approximately \$2.9 trillion, and Freddie Mac's was approximately \$1.8 trillion.

Multifamily

In their multifamily business line, the Enterprises work with a network of lenders to finance apartment buildings across the country. Similar to their single-family business line, the Enterprises purchase loans from private lenders and either hold them in their investment portfolios or securitize and sell them.

Multifamily lending has played an important role in how the Enterprises have fulfilled past affordable housing mandates. However, the Enterprises do not dominate the multifamily market as they do the single-family market. In 2011, Fannie Mae's average multifamily guaranty book of business was approximately \$192 billion, and Freddie Mac's was approximately \$174 billion.

Investment and Capital Markets

The Enterprises third line of business involves management of their sizable portfolios of mortgages, mortgage-related securities, and other investments. In 2011, Fannie Mae had an average total capital markets investment portfolio of \$708 billion, and Freddie Mac had a \$653 billion portfolio.

C. Fannie Mae and Freddie Mac: 2000 – 2008

From 2001 until reaching its peak in 2006, the U.S. housing market experienced a rapid increase in the valuation of real property.¹² This swift escalation is often referred to as the "housing bubble." During this time, Fannie Mae's and Freddie Mac's growth generally mimicked real property values. Fannie Mae's assets and guaranteed mortgages increased from \$1.3 trillion in 2000 to \$3.1 trillion in 2008, or 11% annually. Likewise, Freddie Mac's assets and guaranteed mortgages increased from \$1 trillion in 2000 to \$2.2 trillion in 2008, or 10% annually.

¹² Between 1997 and 2006, home values increased 124%.

The Enterprises average annual growth of 10% or more was stimulated, in part, by aggressive strategies to purchase mortgages and mortgage assets originated under questionable underwriting standards. For example, the Enterprises purchased large volumes of **Alt-A mortgages**, which typically lacked full documentation of borrowers' incomes and had higher than usual loan-to-value or debt-to-income ratios. Additionally, starting in 2001 for Freddie Mac and 2002 for Fannie Mae, the Enterprises began purchasing private-label MBS collateralized by **subprime mortgages**, in order to supplement their investment returns and achieve housing-related goals.

In 2007, housing prices plummeted and loan delinquencies and defaults significantly increased. Fannie Mae and Freddie Mac lost billions of dollars on their multi-trillion dollar MBS guarantee obligations and investment portfolios. The Enterprises' single-family business line incurred the greatest losses by far. This line suffered \$208 billion in capital losses from the end of 2007 through the third quarter of 2011.¹³ As shown in Figure 1 below, from the end of 2007 through the third quarter of 2011, the Enterprises had combined losses of \$261 billion, and single-family losses represented \$208 billion of this total.

Alt-A Mortgage

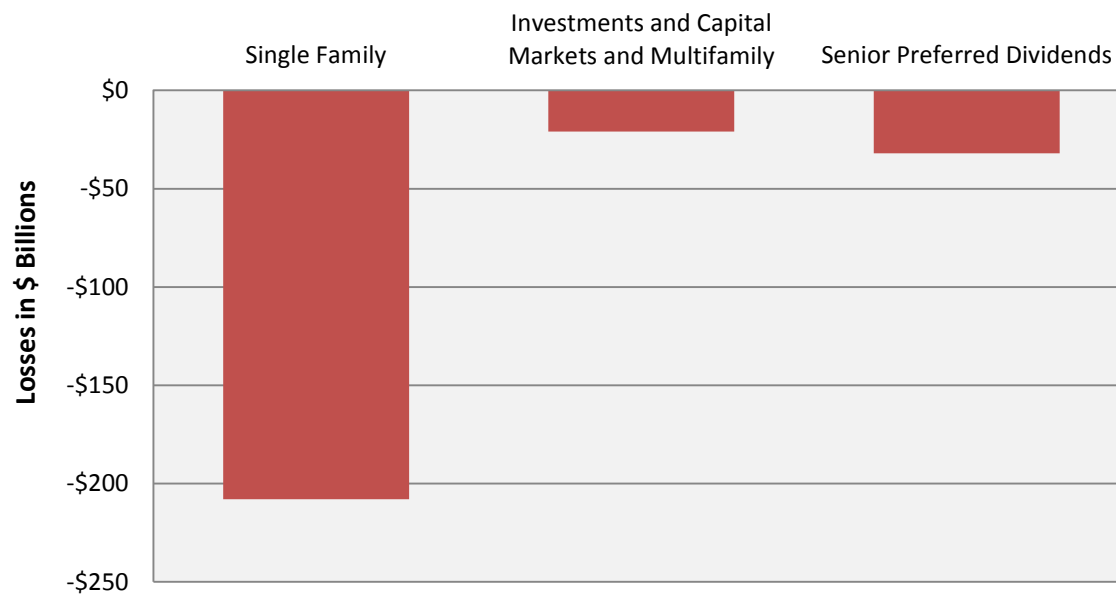
There is no uniform definition of Alt-A mortgages, but a useful working definition is: A classification of mortgages in which the risk profile falls between prime and subprime. The borrowers involved in these mortgages generally have clean credit histories, but the mortgage itself has some issues that increase its risk profile. These issues include higher loan-to-value and debt-to-income ratios or inadequate documentation of the borrower's income.

Subprime Mortgage

There is no uniform definition of subprime mortgages, but a useful working definition is: A type of mortgage that is normally made to borrowers with lower credit ratings. As a result of the borrower's lower credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan. Lending institutions often charge interest on subprime mortgages at a higher rate than a conventional mortgage, in order to compensate themselves for carrying more risk.

¹³ A disproportionate share of these credit losses is from nontraditional and higher-risk mortgages (e.g., Alt-A and subprime mortgages) and is concentrated in loans originated during the housing bubble. However, housing price declines and prolonged economic malaise have also taken a toll on the credit performance of traditional mortgages.

Figure 1: Enterprises Losses from the End of 2007 Through the Third Quarter of 2011¹⁴



Source: Conservator's Report on the Enterprises' Financial Performance, Third Quarter 2011, available at: http://www.fhfa.gov/webfiles/19585/Conservator's_Report112910.pdf, pg. 9.

Additionally, as foreclosures and losses increased, investor confidence in the Enterprises deteriorated. This led to a sharp increase in the Enterprises' borrowing costs and drastic declines in shareholder equity, triggering concerns about their potential failures and the broader implications of the same.

On July 30, 2008, in response to the Enterprises' feeble financial condition and concerns about the stability of the financial markets as a whole, HERA was enacted. HERA established FHFA as the safety, soundness, and housing mission regulator of the Enterprises. Additionally, section 1145 of HERA authorized FHFA to appoint conservators for the Enterprises for a variety of reasons including inability to meet obligations or undercapitalization. This set the stage for the ensuing FHFA conservatorships of the Enterprises.

D. The Conservatorships

Conservatorships Established

A conservatorship is the legal process in which a person or entity is appointed to establish control and conduct oversight of a company, in order to return it to a sound and solvent

¹⁴ The Enterprises had available capital of \$78 billion, so the actual capital deficit through third quarter of 2011 is \$183 billion. This figure matches Treasury's commitments to the Enterprises to date.

condition. In a conservatorship, the powers of the company's directors, officers, and shareholders are transferred to the conservator. On September 6, 2008, the then-FHFA Director appointed FHFA as the conservator for Fannie Mae and Freddie Mac. At the time, FHFA stated:

The purpose of appointing the Conservator is to preserve and conserve the [Enterprises'] assets and property and to put the [Enterprises] in a sound and solvent condition. The goals of the conservatorship are to help restore confidence in [Fannie Mae and Freddie Mac], enhance [their] capacity to fulfill [their] mission, and mitigate the systemic risk that has contributed directly to the instability in the current market.¹⁵

In September 2008, when the conservatorships were created, they were regarded as temporary mechanisms. The then-FHFA Director stated that he hoped that the “[c]onservatorship will give the Enterprises the time to restore the balances between safety and soundness and provide affordable housing and stability and liquidity to the mortgage markets.”¹⁶ Moreover, the then-Treasury Secretary described the conservatorships as a “time-out” to allow policymakers to further consider the future role of the federal government and the Enterprises in the housing finance system.¹⁷

As the Enterprises' conservator, FHFA appointed new Chief Executive Officers for Fannie Mae and Freddie Mac and immediately instructed each Enterprise to examine its underwriting standards and pricing.¹⁸ However, although FHFA initially took control of the Enterprises, it has re-delegated to them many of their essential functions. For example, FHFA has generally delegated:

- To the boards of directors, authority to oversee the Enterprises; and
- To management, authority to conduct the Enterprises' day-to-day operations.

Treasury's Financial Support

Simultaneous with the commencement of the conservatorships, Treasury exercised its authority under HERA “to purchase any obligations and other securities” issued by the Enterprises¹⁹ and

¹⁵ See FHFA, Questions and Answers on Conservatorship, available at: www.fhfa.gov/webfiles/35/FHFACONSERVQA.pdf.

¹⁶ FHFA Statement by Lockhart 9708 final.pdf, at 10.

¹⁷ Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers, September 7, 2008, available at <http://www.treasury.gov/press-center/press-releases/Pages/hpl1129.aspx>.

¹⁸ FHFA_StrategicPlan_2009-2014n, p.30; see also 092308 FHFA Hearing Stmt corrected 092608, pg 6.

¹⁹ Public Law No. 110-289 § 1117.

began to purchase preferred stock pursuant to the Senior Preferred Stock Purchase Agreements (PSPAs). As of December 31, 2011, Treasury has provided \$183 billion in support to the Enterprises under the PSPAs. FHFA predicts that by the end of 2014, Treasury will have invested between \$220 billion and \$311 billion in the Enterprises.

Under the terms of the PSPAs, the Enterprises must make quarterly dividend payments to Treasury at an annual rate equal to 10% of Treasury's outstanding investment. To date, Treasury generally has had to increase its investment in the Enterprises to finance their dividend payments.

Emergency Economic Stabilization Act of 2008

Soon after the Enterprises were placed into conservatorships, and as the financial crisis continued, the Emergency Economic Stabilization Act of 2008 (EESA) was enacted. EESA requires FHFA to:

- Implement a plan to maximize assistance to homeowners;
- Use its authority to encourage the servicers of Fannie Mae and Freddie Mac mortgages, considering net present value, to take advantage of federal programs to minimize foreclosures;
- Coordinate within the federal government concerning homeowner assistance plans; and
- Submit monthly reports to Congress detailing the progress of its efforts.²⁰

The Evolving Nature of FHFA's Conservatorships

FHFA's conservatorships of the Enterprises have evolved over time. As reflected above, FHFA initially viewed the conservatorships as short-term undertakings designed to maintain the Enterprises' business operations. It was – and remains – FHFA's position that it lacks the authority to impose a long-term solution to the Enterprises' situations and that any such solution must be legislative in nature. Thus, early in the conservatorships, FHFA's primary concern was to keep the Enterprises functioning, persuade employees to remain notwithstanding an uncertain future, and ensure the smooth transition of executive management teams.

As time went on and no long-term solution appeared to be imminent, FHFA began to lay the foundations for improving critical aspects of the nation's ailing housing finance system while maintaining the Enterprises' operations over an extended period of time. Starting in early 2010,

²⁰ Public Law No. 110-343 § 110 (Oct. 3, 2008).

FHFA focused on conserving assets, minimizing corporate losses, and ensuring the Enterprises continue to serve their missions. Specific details about these and other programs are discussed in greater detail in Section D, Highlights of FHFA's Conservatorships, under the "Conservatorships in Operation" heading.

More recently, FHFA has issued a strategic plan for the next phase of the conservatorships. The plan focuses on building a new secondary mortgage market infrastructure.²¹

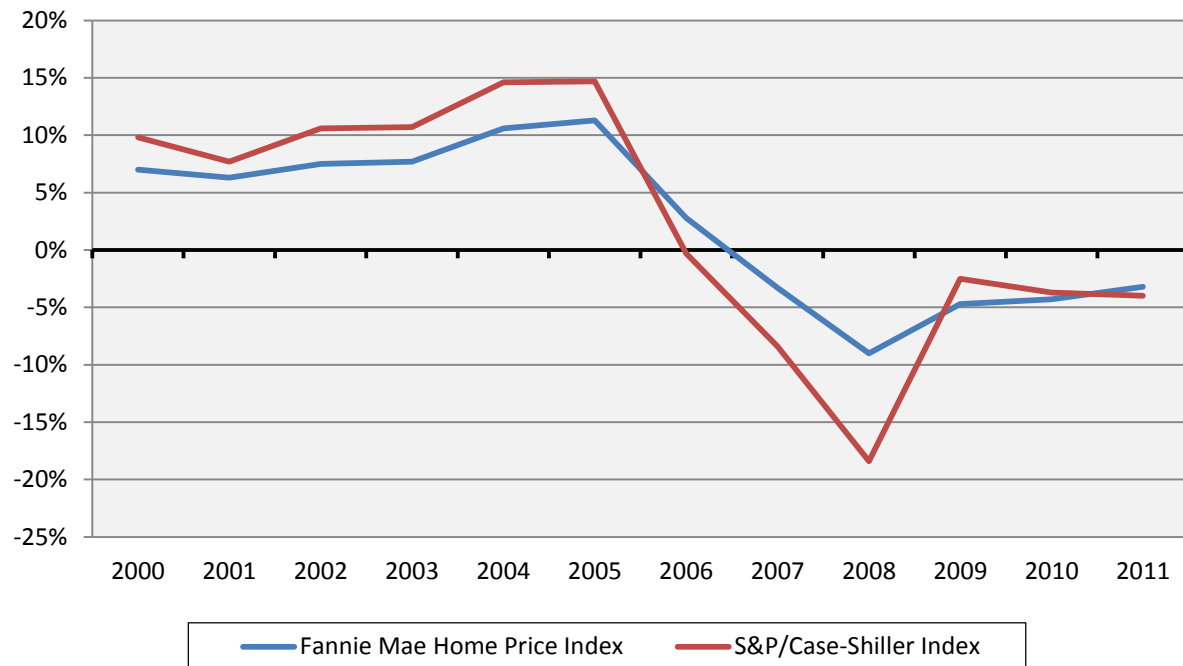
The Fragile U.S. Housing Market

Presently, Fannie Mae, Freddie Mac, and FHA dominate mortgage lending. Combined, they guarantee or insure over 90% of mortgage originations. However, the contemporary housing market pales in comparison to its size during the housing bubble. Since their peak in early 2006, home prices have declined substantially as illustrated by the Fannie Mae Home Price Index and the S&P/Case-Shiller Index, as depicted in Figure 2, below.²²

²¹ FHFA, Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending, (February 21, 2012) pg 4, available at: <http://www.fhfa.gov/webfiles/23344/StrategicPlanConservatorshipsFINAL.pdf>

²² The S&P/Case-Shiller index is a group of indexes that tracks changes in home prices throughout the United States. The indexes are based on a constant level of data on properties that have undergone at least two arm's length transactions. See http://www.investopedia.com/terms/s/sandp_case_shiller_index.asp#ixzz1oGtKuGM7.

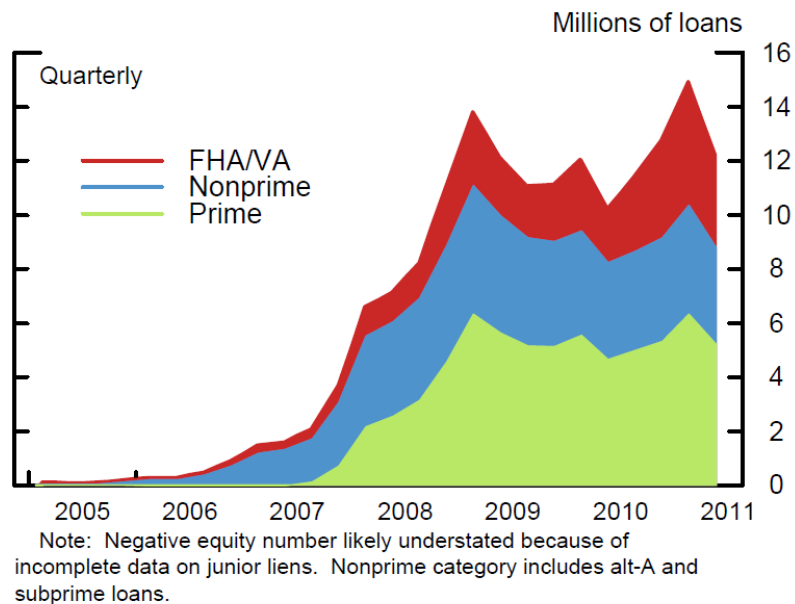
Figure 2: Home Price Growth/Decline Rates in the U.S.



Source: Fannie Mae 2011 Credit Supplement, February 29, 2012, available at: www.fanniemae.com/ir/pdf/sec/2011/q1credit_summary.pdf, pg 3.

Moreover, as the Federal Reserve recently observed, the housing market remains fragile due to massive numbers of “underwater” or “negative equity” mortgages (*i.e.*, instances in which homeowners owe more on their mortgages than their homes are worth). Due to declines in home prices not seen since the Great Depression, about 12 million homeowners – more than 1 out of 5 homeowners with a mortgage – are underwater, as shown in Figure 3, below.

Figure 3: Mortgages with Negative Equity



Source: Federal Reserve white paper, *The U.S. Housing Market: Current Conditions and Policy Considerations*, available at <http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf> (Jan. 4, 2012), Fig. 3.

Further, when housing prices started falling and equity started turning negative, many borrowers lost the ability to refinance their mortgages or sell their homes. The 12 million underwater homeowners now have an aggregate negative equity of \$700 billion.

Conservatorships in Operation

A. FHFA's Duties and Responsibilities

FHFA has a panoply of powers that it may use as a regulator and as a conservator. It also has a number of responsibilities attendant to its dual roles. As regulator, the Agency's mission is to ensure that the Enterprises operate in a safe and sound manner. As conservator, the Agency seeks to conserve and preserve Enterprise assets. As discussed in greater detail below, senior FHFA staff view these roles as often aligning. FHFA also has responsibility under EESA. Figure 4, below, compares and contrasts FHFA's duties and authorities as a regulator under HERA, as a conservator under HERA, and as federal property manager under EESA.

Figure 4: FHFA's Duties and Authorities

Regulator	Conservator	Property Manager
Duties Under HERA: <ul style="list-style-type: none">- Oversee the prudential operation of each regulated entity- Ensure that each regulated entity operates in a safe and sound manner- Ensure that the Enterprises' activities foster liquid, efficient, competitive, and resilient national housing finance markets	Discretionary/Permissive Powers Under HERA (includes any and all powers of the Enterprises' boards, executives, and shareholders including the powers to): <ul style="list-style-type: none">- Put the Enterprises in sound and solvent condition- Preserve and conserve the Enterprises' assets- Control and operate as many or as few aspects of the Enterprises' operations, as desired	Duties Under EESA: <ul style="list-style-type: none">- Implement a plan to maximize assistance to homeowners- Encourage the servicers of Fannie Mae and Freddie Mac mortgages, considering net present value, to take advantage of federal programs to minimize foreclosures- Encourage and facilitate mortgage modifications in cases in which the Enterprises hold an interest in the obligation or pool of obligations

FHFA's Duties as Regulator Under HERA

The principal duties of the director of FHFA as a regulator are to oversee the prudential operations of each regulated entity and to ensure that:

- Each regulated entity operates in a safe and sound manner, and maintains adequate capital and internal controls;

- The operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets. These include activities relating to mortgages on housing for low- and moderate-income families;
- Each regulated entity complies with the rules, regulations, guidelines, and orders issued under law;
- Each regulated entity carries out its statutory mission only through activities that are authorized under law and consistent with the law; and
- The activities and procedures of each regulated entity are consistent with the public interest.²³

HERA also requires that the Enterprises obtain Agency approval before offering new products; prohibits the Enterprises from providing unreasonable executive compensation; requires FHFA to establish prudential management and operational standards for the regulated entities; and forbids high ranking FHFA officials from receiving compensation from the Enterprises within two years of their departure from FHFA.

FHFA's Discretionary/Permissive Powers as Conservator Under HERA

As a conservator, FHFA has discretionary or permissive powers, not specific mandates. FHFA is authorized to:

- Succeed to all rights, titles, powers, and privileges of the Enterprises, and any shareholders, officers, or directors of such Enterprises;
- Operate the Enterprises; and
- Take such action as may be:
 - Necessary to put the Enterprises in sound and solvent conditions; and
 - Appropriate to carry on the business of the Enterprises and preserve and conserve their assets and property.²⁴

²³ See 12 U.S.C. § 4513 *et seq.* for more information on FHFA's statutory duties as a regulator.

²⁴ Public Law No. 110-289 § 1145. For example, under HERA, FHFA can: (1) promulgate regulations regarding the conduct of the conservatorship; (2) take title to all books, records, or assets of the Enterprises; (3) take over the assets of the Enterprises; (4) collect all obligations and money due to the Enterprises; (5) act in the name of the Enterprises; and (6) create contracts to aid in its role.

In addition to those powers enumerated by HERA, FHFA has “such incidental powers as shall be necessary to carry out” its enumerated powers.²⁵ In 2009, FHFA interpreted its authorization to conserve and preserve the Enterprises’ assets as its “top goal” for its conservatorships,²⁶ and often cites this goal.²⁷

FHFA’s Duties Under EESA

EESA requires that FHFA:

- Implement a plan to maximize assistance to homeowners;
- Use its authority to encourage the servicers of Fannie Mae and Freddie Mac mortgages, considering net present value, to take advantage of federal programs to minimize foreclosures;
- Coordinate within the federal government concerning homeowner assistance plans; and
- Submit monthly reports to Congress detailing the progress of its efforts.²⁸

B. Treasury Agreements

Under the PSPAs, the Enterprises agreed to consult with Treasury and obtain its approval for a variety of significant business activities including capital stock issuances and dividend payments; ending the conservatorships; transferring assets; and awarding executive compensation. The PSPAs also outline certain activities that require approval from both FHFA and Treasury. These activities include:

- Certain executive compensation decisions;
- Transferring or disposing of any asset, except for fair market value and in the ordinary course of business;
- Declaring or paying dividends;

²⁵ Id.

²⁶ FHFA July 30, 2009, Speech, p 12.

²⁷ See Statement of Edward DeMarco Before the House Financial Services Committee, Subcommittee on Oversight and Investigations (December 1, 2011) pg 3; see also *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending* (February 21, 2012) pg 10 (“FHFA has reported on numerous occasions that, with taxpayers providing the capital supporting Enterprise operations, this “preserve and conserve” mandate directs FHFA to minimize losses on behalf of taxpayers”).

²⁸ Public Law No. 110-343 § 110.

- Making any distribution of the Enterprises' equity interests;
- Purchasing (directly or indirectly), retiring, or acquiring equity interests in the Enterprises;
- Issuing or selling the capital stock of the Enterprises or any subsidiary;
- Assuming certain debt;
- Merging or consolidating with other entities;
- Reorganizing or recapitalizing the company or any subsidiary involving the Enterprises' common stock;
- Reclassifying common stock of the Enterprises or any subsidiary; and
- Purchasing, leasing, or otherwise acquiring all or substantially all of the assets of another person or entity.

C. FHFA's Governance Milestones

Office of Conservatorship Operations

At the inception of the conservatorships, FHFA created a new organizational unit to handle conservatorship issues: the Office of Conservatorship Operations (OCO), which serves as a principal point of contact between the Agency and the Enterprises. OCO primarily acts as a liaison between the Acting Director of FHFA and the Enterprises to preserve and conserve the Enterprises' assets and property, ensure that the Enterprises appropriately focus on their missions, and facilitate their emergence from conservatorship.²⁹ In 2009, OCO began tracking Enterprise requests for review by the conservator. In October 2010, OCO established a formal system to better manage its communications and track pending issues. FHFA has received

²⁹ A high ranking FHFA employee stated that FHFA has designed affordable housing goals for the Enterprises that the Enterprises can meet without changing their operations from that of a common market player. This realignment minimizes any tensions between the business goals of the Enterprises and their housing mission. Despite this realignment, FHFA's Acting Director has stated that:

Given that the housing goal structure was not designed to address the extended period of time that the Enterprises have been operating in conservatorship, eliminating the goals could be consistent with the current state of the Enterprises. Similarly, the Enterprises' duty to serve requirements that were put in place under HERA, were designed to stimulate the Enterprises to innovate and undertake other activities to address particular markets. Similar to the housing goals, eliminating the duty to serve requirements could be consistent with the realities associated with the Enterprises operating in conservatorship.

See DeMarco Testimony 3-31-11, pg. 14.

approximately 600 requests to date and resolved approximately 525 of them. The requests have included: informational items, items requiring conservatorship approval pursuant to the delegation letters, approval of new products, and other items for which the Enterprises seek approval or non-objection.

The Senior Associate Director of OCO attends most of the Enterprises' board meetings and executive management meetings. Currently, OCO is comprised of six FHFA employees. However, a broader group of Agency personnel support OCO's oversight, on an as needed basis.

Conservatorships Governance Committee

In July 2009, FHFA created the Conservatorships Governance Committee which meets on a weekly basis to coordinate issues that affect the Enterprises' decision-making authorities and ongoing business. The Conservatorships Governance Committee is a committee of senior FHFA executives whose goal is to ensure coordination on regulatory or supervisory matters that may warrant the attention of the conservator. Usually, the Enterprises alert the Conservatorships Governance Committee about upcoming issues through a variety of channels.

FHFA's Conservatorships Rule

On June 20, 2011, FHFA issued a final rule that clarifies the Agency's conservatorship and receivership authorities.³⁰ Pursuant to the rule, as either conservator or receiver, FHFA may take a variety of actions related to running the Enterprises, maintaining their assets, and continuing their missions.³¹ The rule also establishes procedures for determining the priority of claims against the Enterprises, including claims arising out of shareholder lawsuits.³²

³⁰ See 12 C.F.R. Part 1237.

³¹ Specifically, as outlined in the rule, as a receiver or a conservator, FHFA may: (1) take over the assets of and operate the Enterprises with all the powers of the shareholders (including the authority to vote shares of any and all classes of voting stock), the directors, and the officers of the regulated entity and conduct all business of the regulated entity; (2) continue the missions of the Enterprises; (3) ensure that the operations and activities of the Enterprises foster liquid, efficient, competitive, and resilient national housing finance markets; (4) ensure that the Enterprises operate in safe and sound manners; (5) collect all obligations and money due the Enterprises; (6) perform all functions of the Enterprises; (7) preserve and conserve the assets and property of the Enterprises; and (8) contract for assistance in fulfilling any function, activity, action, or duty of the Agency as conservator or receiver.

³² See 12 C.F.R. §§ 1237.7 – 1237.9.

D. Highlights of FHFA's Conservatorships

FHFA's General Approach to Conservatorships

A conservator may choose from many approaches to conservatorship, including:

- Actively managing every aspect of an entity's operations;
- Monitoring the conserved entities' decision-making and stepping in when it feels it is appropriate; or
- Deferring to the conserved entity on most decisions and stepping in only in cases of greater significance.

FHFA has implemented a style of conservatorship more akin to the latter approach. Specifically, FHFA has delegated day-to-day decision-making to the Enterprises, and they are directed to present other matters to FHFA for review or approval.³³ In addition, high ranking FHFA executives from the Office of the Director, OCO, the Division of Enterprise Regulation, the Division of Examination and Programs Support, the Office of Housing and Regulatory Policy, and the Office of Policy Analysis meet weekly to share issues they are aware of regarding the conservatorships.

As described above, FHFA has structured its conservatorships by assigning a small cadre of six employees to monitor conservatorship issues on a full-time basis. The Agency has stated that this characterization understates the resources focused on the conservatorships because a broader

³³ A November 24, 2008, FHFA directive delegates management of day-to-day operations to the Enterprises, with the reservation that the Enterprises need to consult with and obtain FHFA's consent or non-objection before:

- (1) taking actions involving capital stock, dividends, the PSPAs between Treasury and Fannie Mae and Freddie Mac, increases in risk limits, material changes in accounting policy, and reasonably foreseeable material increases in operational risk;
- (2) creating any subsidiary or affiliate or any substantial non-ordinary course transactions with any subsidiary or affiliate;
- (3) acting on matters that relate to conservatorship including but not limited to actions in connection with significant litigation addressing the actions or authority of the conservator, repudiation of contracts, qualified financial contracts in dispute due to conservatorship status, and counterparties attempting to nullify or amend contracts due to conservatorship status;
- (4) taking actions involving hiring, compensation and termination of benefits of directors and officers at the executive vice president level and above and other specified executives;
- (5) taking actions involving retention and termination of external auditors and law firms serving as consultants to the Board;
- (6) settling litigation, claims, regulatory proceedings or tax-related matters in excess of a specified threshold;
- (7) effecting any merger with or acquisition of a business for consideration in excess of \$50 million; and
- (8) taking any action that in the reasonable business judgment of the board at the time that the action is taken is likely to cause significant reputational risk.

group of Agency personnel assist OCO staff. Yet, as discussed in detail in Appendix A, FHFA-OIG's reports to date have found a drawback to this approach has been that FHFA has often relied on the Enterprises' determinations without independently testing and validating them.

FHFA has provided three explanations for its style of conservatorship: efficiency, concordant goals, and operational savings.³⁴

Efficiency

The Acting Director has explained that the Agency's conservatorship style is the most efficient structure for FHFA to use. Specifically, he stated:

[T]he Enterprises would continue to be responsible for normal business activities and day-to-day operations FHFA reconstituted the boards of directors at each Enterprise and charged the boards with ensuring normal corporate governance practices and procedures are in place. The new boards are responsible for carrying out normal board functions, but they remain subject to review and approval on critical matters by FHFA as conservator. The Enterprises are large, complex companies, and this division of responsibilities represents the most efficient structure for carrying out FHFA's responsibilities as conservator.

Concordant Goals

The Acting Director has also explained that Enterprises' goals as private corporations are the same as the government's goals for the conservatorships. Specifically, he stated:

Like FHFA, the Enterprises' boards [of directors] are focused on conserving assets, minimizing corporate losses, ensuring the Enterprises continue to serve their mission, overseeing remediation of identified weaknesses in corporate operations and risk management, and ensuring that sound corporate governance principles are followed.

Operational Savings

FHFA also believes the Agency's conservatorship style is the least costly approach in light of the Enterprises' unknown future. The Acting Director has explained that taking a more active role would:

³⁴ FHFA Conservatorship Letter from DeMarco to Senators Dodd, Bachus, and Shelby, February 2, 2010 at pp 3-4, and DeMarco SBC Testimony November 15, 2011.

[I]nvolve a costly build-up of staff at FHFA with an uncertain long-term future for this work if Congress legislates away the conservatorships. It would also result in greater taxpayer draws to fund this build-up through assessments on Fannie Mae and Freddie Mac. It also raises questions as to the purpose of Enterprise management and boards if FHFA reviews and repeats so much of their work. As I noted earlier in my statement, conservatorship has been predicated on a delegated authority for the Enterprises to run their day-to-day business. This approach is aimed at achieving operational savings and reducing operational risks. I believe changes to this approach would need to demonstrate benefits that outweigh the costs.

Specific Improvement Efforts

During the three-year pendency of the conservatorships, FHFA has implemented a number of initiatives to improve the Enterprises. Several of these initiatives are highlighted below:

Foreclosure Prevention

The Enterprises participate in three foreclosure mitigation efforts: the Home Affordable Modification Program (HAMP); the Home Affordable Refinance Program (HARP); and their own foreclosure mitigation programs. From the start of the conservatorships through December 2011, the Enterprises have completed 2.1 million foreclosure prevention transactions including permanent loan modifications and other forms of assistance. Approximately 1.8 million of these actions – including nearly 1.1 million permanent loan modifications – have allowed borrowers to retain homeownership. About half of all borrowers who received loan modifications in the fourth quarter of 2011 had their monthly payments reduced by over 30%.

On October 24, 2011, FHFA announced changes to its HARP program that included relaxing the limit on the maximum loan-to-value ratio for borrower eligibility, waiving certain representations and warranties, and eliminating the need for certain property appraisals.

Other Programs

FHFA has established limits on executive compensation, halted all lobbying by the Enterprises, and restricted the Enterprises' ability to offer new products or enter into new lines of business. Additionally, FHFA reports that since the conservatorships commenced "several [guarantee fee] price increases have been initiated to better align pricing with risk, and [the Agency] will continue to gradually increase guarantee fee pricing to better reflect that which would be anticipated in a private, competitive market."

In May 2010, FHFA directed the Enterprises to develop uniform standards for data reporting on mortgage loans and appraisals. This directive, which is called the Uniform Mortgage Data Program, is designed to improve the consistency, quality, and uniformity of data that are

collected at the beginning of the mortgage process. FHFA intends that this directive will allow mortgage originators to identify potential defects at the onset of the mortgage process and will improve the quality of mortgage purchases, which may, in turn, reduce repurchase risk for originators. In December 2011, the Enterprises began phasing in these uniform standards and plan to continue implementation throughout 2012.

In April 2011, FHFA began a Servicing Alignment Initiative (SAI) to respond to concerns raised about how delinquent mortgages were being serviced. Beginning October 1, 2011, the Enterprises implemented a single, consistent set of procedures for servicing their delinquent and defaulted mortgages. SAI prioritizes early borrower outreach, streamlines documentation requirements, simplifies mortgage modification terms and requirements, and establishes a schedule of performance-based incentive payments and penalties aimed at ensuring that servicers review foreclosure alternatives in a timely manner.

Challenges Faced by FHFA

FHFA faces significant challenges such as the unique nature of the conservatorships; inherent tensions between the Enterprises' affordable housing goals and their profitability; and inherent tensions between the Enterprises' concurrent roles as conservator and regulator. Additionally, FHFA's extensive and complex operations may further complicate the latter challenge by limiting its ability to separate its dual roles as conservator and regulator. Finally, the length of the conservatorships and the uncertain future of the Enterprises are significant concerns that overshadow all aspects of FHFA's activities.

A. Unique Nature of the Conservatorships

Black's Law Dictionary defines a conservator as a "guardian, protector, or preserver."³⁵ At least since the 1930s, courts have recognized that the broad purpose of a conservator is to maintain a troubled institution as an ongoing concern.³⁶ But, there are very few guideposts illuminating the proper framework of institutional conservatorships. In an effort to garner lessons learned from other institutional conservatorships, FHFA-OIG examined three other agencies that have operated or could operate an institutional conservatorship: the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Farm Credit Insurance Corporation (FCIC). Although these agencies' experiences presented useful information, as discussed further below, none of their experiences are directly comparable because the Enterprises are unique institutions.

HERA's conservatorship/receivership provisions were modeled after the FDIC's conservatorships, so a comparison between FHFA's conservatorships of the Enterprises and the FDIC's conservatorships of depository institutions would appear to be helpful.³⁷ However, practical differences between the Enterprises and depository institutions limit the validity of such comparisons and the value of making them. Indeed, FHFA describes its conservatorships of the Enterprises as the "largest, most complex conservatorship in history."³⁸ Figure 5 below summarizes these differences.

³⁵ *Black's Law Dictionary* - conservator.

³⁶ *Resolution Trust Corp. v. Cedar Minn Building*, 956 F.2d 1446, 1454 (8th Cir.1992); *In re Fannie Mae 2008 Securities Litigation*, 742 F.Supp.2d 382, at *413 (S.D.N.Y. 2010).

³⁷ *In re Federal Home Loan Mortg. Corp. Derivative Litigation*, 643 F.Supp.2d 790, 795 (E.D.Va. 2009).

³⁸ See <http://www.fhfa.gov/webfiles/23344/StrategicPlanConservatorshipsFINAL.pdf>

Figure 5: Comparison of Institutional Conservatorships to Date

	FHFA	FDIC	NCUA	FCIC³⁹
Market Position of Conserved Assets	Vast majority of secondary mortgage market	Individual institutions, generally one at a time ⁴⁰	Individual institutions, generally one at a time	Never implemented but would be Farm Credit System institution
Primary Funding Source for Assets Infused into Conserved Institutions	Taxpayer money through Treasury PSPAs	Insurance payments by FDIC members	Insurance payments by NCUA members	Insurance payments by Farm Credit System members
Financial Institutions Conserved	Fannie Mae, Freddie Mac	Federal and state depository institutions	Federal credit unions and federally insured state-chartered credit unions or corporate credit unions	Farm Credit System member banks and associations
Housing Mission	Yes	No	No ⁴¹	No

FHFA's conservatorships of the Enterprises differ substantially – in both theory and practice – from the conservatorships utilized by the FDIC⁴² and NCUA. First, the primary difference between FHFA's conservatorships and those of the FDIC and NCUA is the nature and scope of the entities subject to conservatorships. Typically, an individual depository institution is one of many such institutions. To the extent that account-holders are made whole, the damage to the broader economy attendant to the dissolution of such an institution is relatively minor. Conversely, the Enterprises are currently responsible for the vast majority of the secondary mortgage market. They cannot be abolished without Congressional approval, and their importance to the secondary mortgage market makes it unlikely that they can be dissolved in very short order without potentially causing catastrophic repercussions throughout the housing finance system.

³⁹ No conservatorship has been implemented under the FCIC model. The Farm Credit System is a government sponsored enterprise.

⁴⁰ At a cost of around \$10.7 billion, IndyMac is the most expensive bank closing, to date, in the FDIC's history. This is small compared to the \$183 billion Treasury had provided the Enterprises as of the end of the third quarter of 2011.

⁴¹ Similar to FHFA's housing mission, the NCUA has a public mission of making credit available in underserved areas. See <http://www.ncua.gov/about/History/Pages/History.aspx>.

⁴² In theory, if the FDIC were to conserve a very large bank, the conservatorship may be similar to that of the Enterprises.

The Enterprises' large sizes and the costs of maintaining them also distinguish them from other conserved institutional entities. For example, from 2007 to 2011, the total value of all of the losses suffered by the NCUA's 7,400 credit unions was between \$5 billion and \$10 billion. The total charges against credit for the Enterprises during the same period were around \$261 billion. Likewise, when IndyMac collapsed in 2008 and FDIC placed it into conservatorship, it was the largest bank collapse in almost 20 years; yet, the failure cost the FDIC around \$10.7 billion – a fraction of the Enterprises' losses since 2007. Further, as stated above, FHFA estimates that the Enterprises will require between \$220 billion and \$311 billion in taxpayer dollars by the end of 2014.

Second, the sources of funding are different. The FDIC, NCUA, and FCIC primarily fund their conservatorship activities by making assessments on the entities subject to their regulation. Thus, whereas premiums paid by healthy depository institutions and credit unions fund, or at least defray, the conservatorship operations of the FDIC and NCUA, FHFA's conservatorships of the Enterprises are supported entirely by money derived from Treasury. This funding may result in FHFA's conservatorships being tasked with responsibilities outside the normal goals of returning the conserved entities to safe and sound conditions.⁴³

Third, there are significant practical differences among the kinds of institutions conserved by the FDIC, NCUA, and FHFA to date. The NCUA and FDIC conservatorships are of individual institutions, generally one at a time. In these cases, the conserved entity is a small enough player in the market that it can be largely abolished through receivership; and placed under new management or returned to solvency through being acquired by a financially sound buyer (or some combination of the two). Under these circumstances, a conservatorship often acts as a temporary stop on the way to a return to solvency. By contrast, the Enterprises have trillions of dollars of assets and obligations; and, thus, their size alone limits the practicality of a manageable resolution/acquisition.⁴⁴

In sum, the Enterprises are so markedly different from other conserved entities that using the FDIC or NCUA models as guideposts may not be feasible.

B. Mission Tensions

FHFA faces considerable outside pressure regarding its responsibilities. The Acting Director described the difficulties this places on the Agency:

⁴³ For example, FHFA faces tensions between the Enterprises' affordable housing mission and profitability as discussed later in this paper.

⁴⁴ As FHFA has stated: "Unlike the banking industry, there are not thousands of potential firms ready to step into the business of mortgage securitization." See www.fhfa.gov/webfiles/23344/StrategicPlanConservatorshipsFINAL.pdf.

Conflicting opinions abound about what our responsibilities should be. Some think FHFA should be doing more to help housing recover, others think that FHFA should be winding down the Enterprises' operations more quickly. . . .⁴⁵

Policies that have emerged since the conservatorships – such as stricter underwriting standards and the “Making Homes Affordable” programs – have revealed a possible tension between the Enterprises' business mission and the preservation and conservation of their assets and the provision of assistance to struggling homeowners.⁴⁶ For example, stricter underwriting standards, which promote the Enterprises' “bottom line” interests, may also make mortgages harder to obtain. Home affordability programs, in essence, do the opposite. Although they promote homeowner assistance, they may add costs and financial risk to the Enterprises and taxpayers.

For instance, an Enterprise's business mission will benefit from the stream of payments received from a high-interest mortgage. Should that mortgage be refinanced at a lower rate, the stream of payments it produces would be lower. This, in turn, would reduce the value of the Enterprises' business investment. However, facilitating the refinance of a high-interest mortgage may also serve to prevent a default. Thus, it could be argued that the choice between advancing business interests and advancing the mission to assist struggling homeowners is, in fact, a false dichotomy – both missions could be advanced by a sound refinancing program.

On the other hand, the vast majority of homeowners with mortgages that exceed the value of their homes are current on their payments. Thus, it could also be argued that an Enterprise that facilitates stream-lined refinancing of mortgages on “underwater” homes may well harm its business mission by granting lower payment rates to homeowners who were not likely to default. Then again, to the extent that an Enterprise facilitates the refinancing only of mortgages that it deems likely to default, or that are already in default, it may be disfavoring unfairly those struggling homeowners who have honored their mortgage obligations. Accordingly, such a policy may have the inadvertent effect of promoting “strategic defaults” by homeowners who would otherwise have continued to make their payments.

FHFA faces challenges in weighing these risks associated with its disparate missions, fulfilling its statutory responsibilities, and choosing appropriate courses of action during the ongoing conservatorships.

⁴⁵ DeMarco Testimony Before the Senate Banking Committee, 2/28/12, pg 6, available at <http://www.fhfa.gov/Default.aspx?Page=30>.

⁴⁶ The Enterprises are also required to provide stability in the secondary mortgage market for low-income, rural, and underserved markets. This responsibility arises from the Enterprises' charters and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended by section 1125 of HERA.

C. Tension Between Roles as Regulator and as Conservator

Senior FHFA employees have stated that FHFA's roles as the Enterprises' conservator and safety and soundness regulator are generally aligned. Specifically, FHFA believes that as a conservator, its mission is to preserve the assets of Fannie Mae and Freddie Mac. Whereas, as the Enterprises' regulator, FHFA has stated that its mission is to ensure the Enterprises provide liquidity, stability, and affordability to the mortgage market in a safe and sound manner. Both as a conservator and as a safety and soundness regulator, FHFA has an interest in ensuring that the Enterprises conduct their businesses and operations in a manner that limits risk-taking.

Similarly, FHFA's actions since the initiation of the conservatorships reflect a general alignment between conservator and regulator objectives. In particular, FHFA has taken steps to reduce the risk associated with business practices that generated billions of dollars of credit losses. Among these steps, FHFA has caused the Enterprises to increase guarantee fees on their MBS.

Although its roles may be generally aligned, FHFA faces challenges in ensuring its independence as a safety and soundness regulator. To the extent that FHFA, as conservator, directs the Enterprises' business activities and operations, its capacity to independently review and critique the outcome of those directives – in its role as a safety and soundness regulator – could become compromised. For example, FHFA could potentially be faced with criticizing its own actions or those of its senior officials. A high ranking FHFA official explained that early in the conservatorships, OCO tapped staff from the examinations team to help with conservatorship issues. In late 2010 and early 2011, FHFA implemented a reorganization to better separate its responsibilities as a conservator from those as a regulator. This included returning examination staff to more traditional supervisory functions.

FHFA, thus far, has avoided this inherent conflict by delegating most of the management of the Enterprises to their boards of directors and managers. But if FHFA were to become a more active conservator, that could increase the potential for tension between its dual roles. Although FHFA's delegated conservator approach in concept may be justified, its implementation has its costs. As discussed in Appendix A, FHFA-OIG has found that in some critical matters, FHFA has unduly relied on determinations of the Enterprises without independently testing and validating the decisions.

The ability of FHFA to manage effectively the conservatorships through a delegated approach may ultimately depend on other factors, such as strong regulatory oversight and enforcement, and robust internal controls at the Enterprises. As discussed in Appendix A, this is an area of concern for FHFA-OIG because in multiple reports, FHFA-OIG identified instances in which FHFA was not active in oversight and enforcement, and Enterprise internal controls were lacking.

Likewise, Appendix A indicates that in several other reports, FHFA-OIG found that FHFA has left some areas bereft of strong regulatory oversight and enforcement and allowed the Enterprises to have inadequate internal controls.

D. An Uncertain Future

The Fannie Mae and Freddie Mac conservatorships were intended to be temporary solutions to a larger problem. Indeed, FHFA has emphasized that the conservatorships “cannot be a permanent state for the Enterprises.”⁴⁷ The lack of guidance about the outcome of the conservatorships has been difficult for the Agency and becomes harder with each passing day. As reflected above, the Agency has found it increasingly difficult to make investments in organizational infrastructure and to make human resources decisions without knowledge as to when – or, indeed, if – the conservatorships can be concluded.

According to the Agency, a conservator’s goal “is to continue the operations of a regulated entity, rehabilitate it and return it to a safe, sound and solvent condition.” Once this has been accomplished, “the Director will issue an order terminating the conservatorship.”⁴⁸ HERA does not limit the duration of the conservatorships, but the statute indicates that Congress intended the conservatorships to be finite. Specifically, the statute states:

The Agency may, at the discretion of the Director, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity.⁴⁹

As a practical matter, however, the Enterprises’ future solvency – and, thus, emergence from the conservatorships – is unlikely without legislative action. FHFA officials have stated that the PSPAs have made it virtually impossible for the Enterprises to emerge from the conservatorships. For example, the Enterprises currently owe Treasury \$183 billion, and are required to pay 10% dividends on Treasury’s outstanding investment. Merely paying the 10% annual dividend (*i.e.*, \$18.3 billion, presently) would not reduce Treasury’s outstanding investment. Moreover, the Enterprises have had to borrow from Treasury at least part of their dividend payments to Treasury, thus increasing the value of their outstanding debt. As a result, it would appear highly unlikely – if not mathematically impossible – for the Enterprises to buy themselves out of the conservatorships. FHFA’s Acting Director has stated that:

⁴⁷ Federal Housing Finance Agency 2008 Report to Congress, p. 3.

⁴⁸ FHFA, Questions and Answers on Conservatorship, p. 2.

⁴⁹ 12 U.S.C. § 4617(a)(2).

[T]he Enterprises will not be able to earn their way back to a condition that allows them to emerge from conservatorship. In any event, the model on which they were built is broken beyond repair. Conservatorship allows the Enterprises to continue serving their public purpose while lawmakers determine the ultimate resolution of the conservatorships and the future legal structure for housing finance⁵⁰

Despite the uncertain future, and pending a long-term congressional resolution, FHFA has created a three-part strategic plan for the conservatorships. FHFA's goals are to: (1) build a new infrastructure for the secondary mortgage market; (2) gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations; and (3) maintain foreclosure prevention activities and credit availability for new and refinanced mortgages. FHFA believes that this plan "leav[es] open all options for Congress and the Administration regarding the resolution of the conservatorships."⁵¹

⁵⁰ DeMarco NC Speech 9 19 11, p5.

⁵¹ FHFA, Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending, (February 21, 2012) pg 4, available at: <http://www.fhfa.gov/webfiles/23344/StrategicPlanConservatorshipsFINAL.pdf>.

Conclusion

The Enterprises play a large and critical role providing liquidity to the housing finance system through the secondary mortgage market. Today, the housing finance system is still fragile. Owners of the vast majority of residential mortgages, Fannie Mae and Freddie Mac, are perhaps the largest victim of this fragility, and, thus, they continue to be dependent on federal support (now totaling \$183 billion) to prevent their insolvency.

Additionally, Fannie Mae's and Freddie Mac's place in the future housing financing system remains highly uncertain. Members of Congress have introduced and continue to introduce legislative proposals defining the future role of the federal government in the secondary mortgage market. Yet, Congress, the Administration, and other policymakers have not agreed upon a definitive path. With dim prospects for a quick recovery of the housing finance system, and ultimate resolution of the Enterprises uncertain, FHFA faces significant challenges continuing to manage effectively Fannie Mae and Freddie Mac.

Scope and Methodology

This white paper is one in a series of audits, evaluations, and special reports reflecting FHFA-OIG's ongoing oversight and analysis of FHFA's conservatorships of the Enterprises.

To gain an understanding of the issues discussed herein, FHFA-OIG interviewed: the Senior Associate Director of OCO; the Chief Financial Officer; and the Deputy Chief Financial Officer of FHFA. FHFA-OIG also interviewed industry officials with experience in institutional conservatorships. Finally, FHFA-OIG utilized a variety of public resources.

FHFA-OIG notes that a potential limitation of this white paper is that it did not interview all Agency officials involved with the conservatorship, but instead relied primarily on publicly available documents. FHFA-OIG also did not submit formal document requests. FHFA-OIG believes this methodological limitation is mitigated by the fact that there have been numerous public statements by then Director James B. Lockhart and Acting Director Edward DeMarco regarding the issues developed herein.

This white paper 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 were promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform evaluations that obtain evidence sufficient to provide reasonable bases for its findings and recommendations. FHFA-OIG trusts that the findings and recommendation contained in this report meet these standards.

The performance period for this special report was from August 2011 to March 2012.

FHFA-OIG appreciates the efforts of FHFA and its staff in providing information and access to necessary documents to accomplish this evaluation.

Appendix A

Trends Identified by FHFA-OIG Reports

FHFA-OIG reports have identified a variety of deficiencies in FHFA's operations, and these deficiencies appear to reflect two significant and related themes. First, with respect to the conservatorships, FHFA often relied on determinations of the Enterprises without independently testing and validating them, thereby giving undue deference to Enterprise decision-making. Second, regarding its regulatory responsibilities, FHFA was not proactive in its oversight and enforcement efforts. As detailed below, both themes have emerged in multiple reports. In addition, FHFA may not have enough examiners to meet its regulatory and conservatorship oversight responsibilities.

A. FHFA's Lack of Independent Testing and Validation of Enterprise Decision-Making

Six FHFA-OIG reports reflect that a side-effect of FHFA's approach as conservator to delegate most business decisions to the Enterprises is that the Agency's oversight is not proactive and often relies upon the Enterprises' review and corporate governance processes. However, FHFA-OIG believes that some matters are sufficiently important to warrant greater involvement and scrutiny by the Agency.

Deferral to Freddie Mac's Analysis of Repurchase Claim Exposure

At the end of 2010, FHFA approved a \$1.35 billion settlement of mortgage repurchase claims that Freddie Mac asserted against Bank of America. In approving the settlement, FHFA relied on Freddie Mac's analysis of the settlement without testing the assumptions underlying the Enterprise's existing loan review process. An FHFA-OIG report found that FHFA did not act timely or test concerns raised by an FHFA senior examiner months prior to the settlement about limitations in Freddie Mac's existing loan review process for mortgage repurchase claims.⁵² The senior examiner was concerned that the loan review process Freddie Mac used for repurchase claims failed to account adequately for changes in foreclosure patterns among loans originated during the housing boom. According to the senior examiner, this could potentially cost the Enterprise a considerable amount of money. Freddie Mac's internal auditors independently identified concerns about the process and, in June 2011, recommended that the issue be studied further. Following initiation of FHFA-OIG's report, FHFA suspended future Enterprise mortgage repurchase settlements premised on the Freddie Mac loan review process and set in motion activities to test the assumptions underlying the loan review process.

⁵² For FHFA-OIG's Evaluation of the Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America, please see <http://www.fhfaoig.gov/Content/Files/EVL-2011-006.pdf>.

Limited Oversight of the Enterprises' Administration of the Home Affordable Modification Program

A key initiative of Treasury's Making Home Affordable program is HAMP, which involves servicers agreeing to modify mortgages for borrowers facing default or foreclosure. In early 2009, the Enterprises began participating in HAMP. The Enterprises entered into five-year agreements with Treasury to manage the program and oversee participants' compliance with program requirements. An FHFA-OIG report found that FHFA largely removed itself from overseeing the negotiations of the agreements and did not engage in any substantive review to evaluate the agreements' feasibility, risks, or the suitability of the Enterprises to serve as Treasury's financial agents. This lack of engagement may have contributed to the agreements' omission of significant details concerning payments to the Enterprises, the scope of their responsibilities, and processes to resolve differences. As a consequence of the omissions, significant problems developed in these areas almost from the beginning, requiring FHFA and the Enterprises to devote substantial time and resources to resolve ambiguities.⁵³

Incomplete Analysis of Executive Compensation at Fannie Mae and Freddie Mac

For 2009 and 2010, the Enterprises awarded their top six officers over \$35 million in compensation. FHFA reviewed and approved these compensation awards based on the Enterprises' determinations and recommendations. However, an FHFA-OIG report found that FHFA did not test or validate the means by which the Enterprises calculated their recommended compensation levels and did not consider factors that might have resulted in reduced executive compensation costs.⁵⁴

Insufficient Transaction Testing

Transaction testing is the method employed by financial institution examiners to arrive at independent impressions about the financial and operational conditions of an institution (*e.g.*, mortgage company, bank, *etc.*) as well as its compliance with applicable laws and regulations. An example of transaction testing would be reviewing a regulated entity's loan files to test the veracity of statements concerning loan underwriting and performance. During an evaluation of FHFA's capacity to examine the government-sponsored enterprises (GSEs), a senior FHFA manager acknowledged to FHFA-OIG that examiners too often accept assertions made by

⁵³ For FHFA-OIG's Evaluation of the Federal Housing Finance Agency's Role in Negotiating Fannie Mae's and Freddie Mac's Responsibilities in Treasury's Making Home Affordable Program, please see <http://www.fhfaoig.gov/Content/Files/EVL-2011-003.pdf>.

⁵⁴ For FHFA-OIG's Evaluation of the Federal Housing Finance Agency's Oversight of Fannie Mae's and Freddie Mac's Executive Compensation Programs, please see <http://www.fhfaoig.gov/Content/Files/Exec%20Comp%20DrRpt%2003302011%20final,%20signed.pdf>.

Enterprise managers rather than validate such assertions through appropriate transaction testing.⁵⁵ This may be related to FHFA having too few examiners to ensure the efficiency and effectiveness of its examination program. As illustrated below, this is also indicative of the second emerging trend: that the Agency was not proactive in its oversight and enforcement efforts.

Limited Oversight of Legal Expenditures

Between 2004 and October 31, 2011, Fannie Mae paid out \$99.4 million in legal expenses for the defense of lawsuits, investigations, and administrative actions against three former senior executives; the Enterprise paid considerable additional sums for other executives. Additionally, Freddie Mac has paid \$10.2 million in legal defense costs for former senior executives since its conservatorship began. To their credit, Fannie Mae and Freddie Mac have taken steps to manage costs associated with lawsuits against their indemnification-eligible directors and officers. However, an FHFA-OIG report found that – despite the Enterprises’ large outlays for legal expenses – the Agency has never independently validated the Enterprises’ processes for determining the reasonableness or the validity of the legal services provided on behalf of their executives or the bills presented for such services.⁵⁶

Insufficient Allocation of Resources to Processing Consumer Complaints

In 2011, FHFA-OIG conducted an audit of the Agency’s consumer complaints process and concluded that FHFA’s oversight of the receipt, processing, and disposition of consumer complaints of fraud, waste, and abuse (including foreclosure abuses) was inadequate.⁵⁷ The Agency had failed to prioritize consumer complaints, and this had consequences. For example, FHFA did not identify complaints requiring resolution in advance of time-sensitive events like foreclosure or other legal proceedings. Consequently, borrowers might not have received help in time. The lack of prioritization and process also cost FHFA the opportunity to perform routine substantive analysis to identify trends and potential risk areas. Such information could have served as an “early warning system” for emerging problems, such as the foreclosure document controversy. Finally, the failure to focus on consumer complaints missed important fraud allegations. For example, in June 2008, serious allegations of fraud involving Taylor, Bean & Whitaker Mortgage Corp. were reported to OFHEO; yet, OFHEO and subsequently FHFA did

⁵⁵ For FHFA-OIG’s Evaluation of Whether FHFA has Sufficient Capacity to Examine the GSEs, please see <http://www.fhfaoig.gov/Content/Files/EVL-2011-005.pdf>.

⁵⁶ For FHFA-OIG’s Evaluation of FHFA’s Management of Legal Fees for Indemnified Executives, please see <http://www.fhfaoig.gov/Content/Files/EVL-2012-002.pdf>.

⁵⁷ For FHFA-OIG’s Audit of the Federal Housing Finance Agency’s Consumer Complaints Process, please see <http://www.fhfaoig.gov/Content/Files/AUD-2011-001.pdf>.

not provide adequate follow-up on the allegations. Taylor, Bean & Whitaker turned out to be a \$2.9 billion mortgage fraud case, one of the largest in history, and involved significant losses to Freddie Mac. Freddie Mac's losses might have been less had the 2008 fraud allegation received prompt attention.

B. FHFA Was Not Proactive in Oversight and Enforcement

As illustrated by multiple reports described below, FHFA-OIG has identified instances in which FHFA was not proactive in its oversight and enforcement. Accordingly, within its regulatory functions, the Agency faces challenges in its ability to identify new and emerging risks potentially impacting the GSEs; establish guidelines and policies governing Enterprise oversight; and provide strong, consistent enforcement for violations of policy.

FHFA Did Not Identify New and Emerging Risks Potentially Impacting the GSEs

FHFA-OIG's work has raised concerns with the Agency's ability to identify and act on early indicators of risk.

For example, there were indicators as early as 2006 that could have led FHFA (and its predecessor) to identify the heightened risk posed by foreclosure processing abuses within Fannie Mae's default-related legal services network.⁵⁸ Indicators such as a significant increase in foreclosures accompanying the deterioration of the housing market, consumer complaints alleging improper foreclosures, contemporaneous media reports of foreclosure abuses, and public court filings in Florida and elsewhere highlighting such abuses should have triggered careful assessment and action by FHFA. Notwithstanding these indicators, FHFA did not devote attention to this issue until August 2010.

A recent FHFA-OIG report on mortgage servicing identified another instance in which the Agency missed opportunities to identify risks.⁵⁹ As of June 30, 2011, Freddie Mac had a mortgage servicing portfolio containing nearly 12 million mortgages with an unpaid principal balance of nearly \$1.8 trillion. When Freddie Mac, or either of the Enterprises, purchase mortgages they enter into contracts with mortgage servicers to collect mortgage payments, set aside taxes and insurance premiums in escrow, forward interest and principal payments to the contractually designated party, and respond to payment defaults. As early as 2008, FHFA had information indicating that mortgage servicing represented a heightened risk to the Enterprises. Specifically, through its off-site monitoring activities FHFA noted a substantial increase in the

⁵⁸ For FHFA-OIG's Audit of FHFA's Oversight of Fannie Mae's Default-Related Legal Services, please see <http://www.fhfaoig.gov/Content/Files/AUD-2011-004.pdf>.

⁵⁹ For FHFA-OIG's Evaluation of FHFA's Supervision of Freddie Mac's Controls over Mortgage Servicing Contractors please see <http://www.fhfaoig.gov/Content/Files/AUD%202012-001.pdf>.

number of Enterprise delinquent loans starting in 2008. In early 2009, FHFA became aware of servicers' poor performance and weaknesses in Freddie Mac's oversight of its servicers. Yet, FHFA did not take timely or appropriate action to address these indicators. Even now, FHFA has not clearly defined its role regarding servicers or sufficiently coordinated with federal banking regulators about risks and supervisory concerns with individual servicers.

FHFA Has Not Always Managed Risk Well by Establishing Guidelines and Policies Governing Enterprise Oversight

Even when FHFA has identified risks, the Agency has not always managed those risks through establishing sufficient regulations or guidance. For example, the recent servicing report found that FHFA has not developed sufficient regulations or guidance governing the Enterprises' oversight and risk management of servicers. Specifically, FHFA has not established and implemented effective Enterprise regulations or guidance controlling the reporting of critical servicer information and establishing baseline requirements for mortgage servicing. Instead, FHFA relies on the Enterprises to individually monitor counterparty risk as part of their ongoing risk management activities.

Similarly, as described in FHFA-OIG's recent report on default-related legal services, FHFA has not developed sufficient regulations or guidance governing the Enterprises' oversight and risk management of default-related legal services. In its report, FHFA-OIG found that FHFA has neither an ongoing risk-based supervisory plan detailing examination and continuous supervision of default-related legal services, nor finalized examination guidance and procedures for use in performing targeted examinations and monitoring of such services. Moreover, FHFA does not have a formal process to address performance problems associated with law firms that have relationships – either directly through contract or through its loan servicers – with both of the Enterprises.

FHFA Has Not Consistently Enforced Directives for Violations of Policy

Even in instances in which FHFA has identified risks and taken steps to manage those risks, the Agency has not been consistent in enforcing its directives to ensure that the risks are, in fact, adequately addressed. As Fannie Mae's conservator and regulator, FHFA's authority over the Enterprise is broad and includes the ability to discipline or remove Enterprise personnel to ensure compliance with Agency mandates. However, an FHFA-OIG report found that FHFA has not exercised this or other authorities to compel Fannie Mae's compliance with the requirement to have an effective operational risk requirement.⁶⁰ Fannie Mae's lack of an acceptable and

⁶⁰ For FHFA-OIG's Evaluation of the FHFA's Oversight of Fannie Mae's Management of Operational Risk, please see <http://www.fhfaoig.gov/Content/Files/EVL-2011-004.pdf>.

effective operational risk management program may have resulted in missed opportunities to strengthen oversight of law firms with which it contracts to process foreclosures.

Further, insufficient enforcement by FHFA is not limited to the Enterprises. Since at least 2008, four Federal Home Loan Banks (FHLBanks) have faced significant financial and operational difficulties, primarily due to their investments in certain high-risk mortgage securities. FHFA has oversight responsibility for the FHLBanks and recognizes the need to ensure that they do not abuse their GSE status and engage in imprudent activities. Yet, an FHFA-OIG report found that FHFA has not established a consistent and transparent written enforcement policy for the FHLBanks classified as having the most “supervisory concerns” within the FHLBank system.⁶¹ This has contributed to instances in which FHFA has not acted to proactively hold FHLBanks classified as “supervisory concerns” and their officers sufficiently accountable for engaging in questionable risk taking.

C. FHFA May Not Have Enough Examiners to Meet Its Regulatory and Conservatorship Oversight Responsibilities

FHFA has critical regulatory responsibilities with respect to the GSEs and conservator responsibilities regarding the Enterprises. To satisfy these responsibilities, Congress provided FHFA significant budget and hiring authority. Nonetheless, an FHFA-OIG report noted that the Agency has too few examiners to ensure the efficiency and effectiveness of its GSE oversight program; due to examiner shortages, FHFA has scaled back planned work during examinations, and examinations have often taken much longer than expected to complete.⁶² Additionally, FHFA-OIG has identified shortfalls in the Agency’s examination coverage, particularly in the crucial area of Real Estate Owned. These limitations stem from insufficient examination capacity and make FHFA’s early identification of possible risks more challenging.

⁶¹ For FHFA-OIG’s Evaluation of FHFA’s Oversight of Troubled Federal Home Loan Banks, please see <http://www.fhfaoig.gov/Content/Files/Troubled%20Banks%20EVL-2012-001.pdf>.

⁶² For FHFA-OIG’s Evaluation of Whether FHFA has Sufficient Capacity to Examine the GSEs, please see <http://www.fhfaoig.gov/Content/Files/EVL-2011-005.pdf>.

Appendix B

The Evolving Federal Role in Housing Finance

The Early Years

1934	• Congress creates the Federal Housing Administration (FHA)
1938	• Congress creates Federal National Mortgage Association (Fannie Mae)
1954	• Congress amends Fannie Mae's charter to change it from a government corporation into a "mixed-ownership corporation"
1968	• Fannie Mae is reorganized as a publicly-traded company
1970	• Congress creates the Federal Home Loan Mortgage Corporation (Freddie Mac)
1989	• Freddie Mac becomes a publically-traded, shareholder-owned company
1992	• Congress creates the Office of Federal Housing Enterprise Oversight (OFHEO) to regulate Fannie Mae and Freddie Mac

Conservatorship

July 2008	• Congress enacts the Housing and Economic Recovery Act of 2008 (HERA) creating FHFA from OFHEO and other agencies
September 6, 2008	• FHFA places the Enterprises in conservatorship
September 7, 2008	• The Enterprises and the Department of the Treasury enter into Senior Preferred Stock Purchase Agreements (PSPAs)
September 26, 2008	• Enterprises and Treasury amend PSPAs: Treasury agrees to make up to \$100,000,000,000 in funding immediately available for withdrawal
October 3, 2008	• Congress enacts the Emergency Economic Stabilization Act of 2008 (EESA)
October 2008	• FHFA creates the Office of Conservatorship (OCO) to act as a liaison between FHFA and the two Enterprises
November 24, 2008	• FHFA issues the "delegation memo" to the Enterprise that provides them with issues they need to consult with FHFA on and obtain FHFA's consent or non-objection before acting
May 6, 2009	• Enterprises and Treasury amend PSPAs to change the maximum amount to be provided to the Enterprises to \$200,000,000,000
July 2009	• FHFA creates the Conservatorship Governance Committee to ensure coordination on regulatory or supervisory matters that may warrant the attention of the Conservator
December 24, 2009	• Enterprises and Treasury amend PSPAs to change the maximum amount to be provided to the Enterprises to \$400,000,000,000 over the amount drawn as of December 31, 2010
October 2010	• OCO implements a status report protocol to track issues coming from the Enterprises
June 20, 2011	• FHFA enacts a Rule which implements authorities under HERA